MONITORING REPORT
MUNICIPAL INFRASTRUCTURE FINANCING PROGRAM
CZECH REPUBLIC

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EXECUTIVE SUMMARY AND POLICY ISSUES[1]

The year ending March 31, 1997 witnessed important developments in the Municipal Infrastructure Finance Program, as well as in the Czech municipal credit market and the Czech economy generally. This Executive Summary highlights the most important developments and the policy issues the Program now faces.

MUFIS' OPERATIONAL RECORD

MUFIS is a financial intermediary which borrows funds from international or domestic markets, and on-lends the funds to Czech commercial banks for the purpose of making housing-related infrastructure loans to municipalities. Under the terms of the 1996 amendment to the Program Agreement, MUFIS may also purchase municipal bonds. To date, MUFIS has raised all of its funds for on-lending from U.S. Housing Guaranty resources.

During the year under review, MUFIS fully disbursed its first and second tranches totaling US$20 million of Housing Guaranty [HG] loan funds. MUFIS began financing additional loans from reflows of principal. It also purchased its first municipal bonds.

On March 27, 1997, MUFIS received its third tranche of HG loan funds, in the amount of US$14 million. It now projects that it will disburse at least 70 percent of these funds during calendar 1997.

By the end of the period under review, MUFIS had made 27 loans to four different commercial banks to support their long-term lending to municipalities to help finance local infrastructure projects. It had purchased a portion of one municipal bond issue. All interest and principal payments owed by banks to MUFIS had been paid on time and in full. All interest and principal payments owed by municipalities to participating banks had been paid on time and in full.

Policy Issues

Looking to the future, four key sources of uncertainty surround MUFIS' loan development:

(1) Uncertainty over the status of the HG program within USAID has created difficulty for MUFIS' intermediate and long-term planning. For most of the year under review, MUFIS did not know when, or whether, it would receive the third-tranche HG loan. Participating banks stopped reviewing projects for MUFIS financing because of this uncertainty. In fact, HG funds were delayed

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[1] A draft of this report has been reviewed by Fred VanAntwerp and Leos Jirasek of USAID-Prague, who have been responsible for field administration of the Municipal Infrastructure Finance Program. All opinions expressed in the report, however, are those of the authors.

a full year beyond MUFIS' planning target. The interruption in the program cost MUFIS credibility in the market place, and has delayed disbursement of the third tranche. Presently, even greater uncertainty surrounds future possibilities of HG borrowing, making it virtually impossible for MUFIS to plan for its institutional development.

(2) MUFIS' longer-term role in the Czech municipal credit market remains unclear. Czech commercial lenders now can adequately serve most of the financing needs of medium-sized and larger municipalities. Development of the commercial market has been aided substantially by MUFIS' activity and by USAID technical assistance to commercial banks and municipalities. The very success of these efforts, however, raises questions about MUFIS' future role. Should MUFIS begin to phase out its activity, having served its transitional function, or should it specialize in serving certain segments of the market (such as the credit needs of small municipalities) that are not being met by the commercial sector? More than 90 percent of the 6,200 Czech municipalities have a population of less than 4,000, making credit supply to the small-municipality market a much more important policy issue than it would be in other countries.

(3) Recent events in the Czech financial sector have resulted in MUFIS having a cost advantage over other Czech institutions in obtaining funds for municipal lending. Financial pressure in 1996 and 1997 produced a de facto devaluation of the Czech crown and has driven up domestic interest rates. MUFIS, however, is protected by special agreement with the Ministry of Finance from the consequences of foreign exchange losses. As a result, its cost of funds is lower than that of institutions who must raise financing domestically or cover foreign exchange risk. MUFIS has passed on this cost advantage to participating banks and municipal borrowers. MUFIS' favorable on-lending rate has increased demand for program loans. However, it raises a basic policy question of whether MUFIS' on-lending under these conditions effectively supports development of the private municipal credit market or uses public subsidy (in the form of coverage of foreign exchange losses) to compete with private institutions that are using their own resources.

(4) The banking sector has gone through a period of severe adjustment in the Czech Republic. Two of the banks with which MUFIS originally signed Master Agreements have been the object of intervention by the Czech National Bank, due to unacceptably high rates of non-performing loans. MUFIS appears to be adequately protected against loss on all of its lending to date. However, the shakeout in the banking sector makes it even more critical than previously for MUFIS to carry out a prudent assessment of banks' financial position before enrolling them as participants in the third tranche. MUFIS does currently screen bank applicants to the Program for creditworthiness; it has not publicly released the financial standards banks must achieve to participate.

MUNICIPAL BORROWING AND MUNICIPAL INVESTMENTS

MUFIS supports lending to a broad spectrum of municipalities. Twenty-one of the 27 MUFIS loans have been made to municipalities having less than 10,000 population. All loans have been made outside the City of Prague. This evolution supports the program objective of making credit available to the full range of Czech local authorities.

MUFIS lending also has helped the municipal credit market move away from extreme dependence on real property as collateral. Fourteen of the 27 MUFIS loans do not require real property collateral. Formerly, essentially all municipal loans were backed by pledges of real property. A variety of innovative security agreements have been written into MUFIS loans, including the indirect pledging of future revenue streams to support municipal borrowing. Future revenue streams cannot be pledged directly as collateral under Czech law.

On the whole, the municipalities borrowing through MUFIS have maintained prudent debt levels. There are a few cases, however, where municipalities' total debt service burden (including MUFIS loans, commercial bank loans, and state loans) is very high--including two cases where the municipal debt service ratio exceeds 34 percent. These cases deserve to be monitored closely, not simply for payment of MUFIS loans but for timely servicing of all debt.

A total of 41 local investment projects have been financed by MUFIS loans. Projects are concentrated in the environmental area, but also include historic district restoration and economic development projects related to housing. Twelve of the 27 loans involved at least 25 percent or more capital cost recovery through service pricing. This rather modest record of cost recovery is likely to increase in the future, as local budgets come under greater financial pressure.

Policy Issues

Close monitoring of the total debt service burdens of MUFIS borrowers is called for. USAID and MUFIS may wish to consider establishing guidelines regarding debt service limits for its municipal borrowers, if the Government does not establish national borrowing limits.

MUFIS' INSTITUTIONAL CAPACITY AND FUTURE DEVELOPMENT

MUFIS greatly improved its financial management in 1996. It narrowed its operating loss from Kč 11.4 million to Kč 2.05 million. Before transfers to reserves, MUFIS' operating loss in 1996 was less than Kč 400,000 (US $13,000).

The improvement in operating results reflects full disbursement of the first and second tranche funding, as well as better cash management. As recommended in the 1996 Monitoring Report, MUFIS' Supervisory Board established clear written guidelines regarding cash management, which instructed MUFIS to invest short-term cash in instruments with favorable yields after withholding taxes. This policy substantially strengthened 1996 earnings and should have further payoff in management of the $14 million received from the third-tranche HG loan.

MUFIS has decided to perform its administrative and cash management activities through a contract with the Czech and Moravian Guaranty and Development Bank (CMZRB), rather than through hiring its own staff. Given the uncertainty surrounding MUFIS' future level of business, this is a sound decision. CMZRB charges 0.2 percent of MUFIS' outstanding loan principal amount as its management fee.

Policy Issues

The MUFIS program is exposed to currency fluctuations. It borrows from the U.S. market in dollars, but lends to the domestic market in Czech crowns. Because the Czech crown lost value in 1996 and 1997, the true cost of MUFIS' HG borrowing has been very high. If MUFIS had repaid the HG loan on March 15, 1997, after two years, the total cost of funds to it, expressed in crowns, would have been 16.8 percent per year. This rate is well in excess of the cost of capital on the domestic market. It illustrates the risks of borrowing in foreign currency. Since March 15, 1997, the loss of value of the Czech crown has accelerated, increasing still further MUFIS' true cost of borrowing.

Of this total cost, MUFIS as an institution has faced a cost of capital of only 9.06 percent on its first and second tranche borrowing and of 8.31 percent on the third tranche. The remaining costs are due to exchange rate losses that are being absorbed by the Ministry of Finance.

If MUFIS intends to maintain a long-term presence as a financial intermediary, it should develop plans for tapping the domestic credit market for financing as well as international markets. Meanwhile, it is appropriate for USAID, MUFIS, and the Ministry of Finance to jointly consider whether MUFIS' on-lending rate should be adjusted to reflect the program's true cost of funds as well as domestic interest rates.

MUFIS has established numerous financial relations with the Czech and Moravian Guarantee and Development Bank (CMZRB), its founder and 49 percent owner. CMZRB handles MUFIS' administrative responsibilities and carries out cash management under a management contract with MUFIS. Much of MUFIS' cash on hand has been invested in CMZRB financial instruments, sometimes at below-market rates of interest. CMZRB has sold to MUFIS a portion of the only municipal bond it has underwritten.

These financial connections make it important that arm's-length relations are maintained between MUFIS and CMZRB, as well as between MUFIS and other institutions represented on the Board of Supervisors or Executive Board.

It is recommended that all financial transactions between MUFIS and institutions affiliated with members of either its Board of Supervisors or Executive Board be committed to writing and require the signature of two outside members (i.e., two Board members who are not affiliated with the institution in question). At present, proposed MUFIS bank loans, for example, require the approval of any two members of the Executive Board.

OVERALL DEVELOPMENT OF THE CZECH MUNICIPAL CREDIT MARKET

The Czech municipal credit market has developed very rapidly since 1993, both in terms of commercial bank lending and the issuance of municipal bonds. The total commercial debt of municipalities increased by more than ten times between 1993 and 1996. At the same time, central government capital subsidies and central government construction on behalf of municipalities declined sharply. As called for in the Policy Action Plan, commercial lending has substantially replaced state subsidies in the financing of local infrastructure investment.

Commercial lending to municipalities also has been restructured to emphasize longer-term credit. In 1993, 31.8 percent of commercial bank loans to municipalities were short-term (less than one year); by the end of 1996, the short-term share of bank credit had fallen to 5.8 percent. Long-term bank lending (four years or longer) rose from 26.9 percent of all bank loans in 1993 percent to 68.8 percent in 1996. This transformation of the municipal credit market is virtually without precedent worldwide.

The municipal bond market also has grown rapidly. Municipal bonds have been issued by 19 municipalities, both in the domestic Czech market and in the European market. Total municipal bond credit increased from 300,000 Kč at the end of 1993 to 11.9 billion Kč at the end of 1996. Total municipal bond debt outstanding now exceeds total bank credit in the municipal sector. All municipal bonds have maturities between five and ten years, adding to long-term financing. A segmentation of the credit market has developed, in which large volumes of borrowing by larger cities are handled through the bond market while smaller credits are handled as traditional bank loans.

As of the ending date of this report, there had been no defaults in the Czech Republic on either commercial-bank municipal loans or municipal bonds. The largest bank lender to municipalities, the Czech Savings Bank, reported a problem loan rate--loans past due by 30 days or more--of less than 1 percent.

Policy Issues

The Czech economy has come under strain in 1996 and 1997. As a result, central government tax sharing with local governments has fallen below budgeted levels and state transfers to municipalities have been cut back. For the first time since 1993, the investment share of local budgets failed to increase during the year under review.

This deterioration of the economy poses a variety of issues for 1997 and the future. First, the loss of other revenues may lead some municipalities to try to borrow more heavily. The sharp increase in interest rates registered in Spring 1997 also has added to the debt servicing burdens of municipalities. Up to now, despite the rapid growth of municipal debt, borrowing levels for the sector as a whole have been conservative. The Government, however, has proposed the establishment of debt ceilings to protect municipalities against excessive borrowing in the future.

Second, interaction between subsidized (zero-interest) state lending to municipalities and commercial lending deserves careful monitoring. Municipal lending by the State Environmental Fund, Ministry of Agriculture, and District Offices has increased rapidly. Any weakness in municipal debt servicing is likely to appear first within this parastatal sector. If tolerated there, it may infect the commercial credit market.

Third, future development of the Czech credit market badly needs an independent, third party capable of assessing municipal credit risk. USAID has sponsored seminars on the credit-rating function including representatives of Standard & Poor’s, and has provided information on state-level institutions in the U.S. which assess municipal credit risk and serve as a link with the commercial credit market. One or more institutions of this type capable of independently assessing credit risk would help bring the Czech municipal credit market to the next stage of development.

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ABBREVIATIONS

AGB	Agrobanka
CEZ	Czech Electricity Company (České energetické závody)
CMZRB	Czech and Moravian Guarantee and Development Bank (Českomoravská záruční a rozvojová banka)
CNB	Czech National Bank (Českà národni banka)
CS	Czech Savings Bank (Českà spořitelna)
EU	European Union
GDP	Gross domestic product
HG	Housing Guaranty
IPB	Investiční a poštovni banka
KB	Komerční banka
Kč	Czech crown
MoF	Ministry of Finance
MUFIS	Municipal Finance Company (Municipálni finanční společnost)
PRIBOR	Prague Inter-Bank Offering Rate
RNB	Riggs National Bank
SEF	State Environmental Fund
USAID	United States Agency for International Development
UTC	Union of Towns and Communities

I. INTRODUCTION AND PURPOSE OF STUDY

1.01 This annual monitoring report examines progress under the capital component of the Municipal Infrastructure Finance Program established by Program Agreement between the Government of the Czech Republic represented by the Ministry of Finance and the Municipal Finance Company (MUFIS), j.s.c., on the one side, and the Government of the United States, represented by USAID, on the other. It continues the program monitoring specified in the Program Agreement, and is intended to provide the parties to the agreement information that they can use in assessing program progress and shaping future program design.

1.02 The Program consists of mutually supporting capital and technical assistance. The first and second tranches of capital assistance, consisting of a US$20 million Housing Guaranty loan from U.S. investors, were received by MUFIS on March 15, 1995. The third tranche in the amount of US $14 million was received on March 27, 1997. Technical assistance to help establish the Program and its policy objectives began in early 1993. The Program Agreement was signed May 16, 1994.

1.03 This report reviews Program activity as of Spring, 1997. A cut-off date of March 31 was used for MUFIS' loan applications, disbursements, and loan repayments. MUFIS' financial records were examined for the calendar year ending December 31, 1996, which is identical with MUFIS' fiscal year. Information on development of the overall Czech municipal credit market is presented formally through the end of 1996. However, wherever key information was available on market developments or MUFIS performance after the cut-off dates, this information is noted in footnotes or in the text.

1.04 The Program Agreement contains a Policy Action Plan (Annex B) which spells out the policy objectives of the Program and the indicators that should be used to measure progress toward these objectives. Following this Introduction, the report is divided into five Sections, corresponding to the Program objectives:

Section II provides a summary description of the Program's disbursement and loan repayment record.

Section III describes the municipal investment projects that are being financed through MUFIS' on-lending and the structure of the commercial bank loans to municipalities that have been financed under the MUFIS program.

Section IV contains information on MUFIS' financial operations and the institutional capacity of MUFIS both to perform its current role and possible future functions.

Section V examines the aggregate development of the municipal credit market and municipal infrastructure financing in the Czech Republic. From the beginning, the Program has sought to influence the overall course of the municipal credit market, rather than to establish an isolated financing institution.

Section VI examines progress toward each of the five policy objectives specified in the Policy Action Plan, and also provides other institutional and policy information relevant to judging the Program's impact to date.

1.05 In carrying out the monitoring study, The Urban Institute and Urban Research staff interviewed: (a) six of the nine banks formally enrolled in the system during 1996, including all of the banks that have approved or currently are considering loans to municipalities through MUFIS, (b) the principal commercial lender to municipalities in the Czech Republic, Česká spořitelna, which to date has not participated in MUFIS lending operations, (c) mayors and other officials of each of the twenty seven municipalities which had signed a loan agreement with participating banks as of March 31, 1997, (d) the MUFIS administrative staff, as well as members of its board of directors and supervisory board, (e) officials of the Ministry of Finance, (f) USAID officials, and (g) independent experts involved in the municipal credit sector in the Czech Republic.

II. OPERATIONAL RECORD OF THE MUFIS PROGRAM

2.01 MUFIS is a financial intermediary which borrows funds from international or domestic markets, and on-lends the funds to Czech commercial banks for the purpose of making housing-related infrastructure loans to municipalities. Under the terms of the 1996 amendment to the Program Agreement, MUFIS may also purchase municipal bonds.

2.02 **Bank Participation**. MUFIS' selection of commercial banks to participate in the Program is based on banks' expression of interest and their financial soundness. Since banks are obligated to repay MUFIS loans whether or not they are paid by municipalities, sound financial condition of the lending banks is crucial. The evaluation of banks' financial condition is based on data provided by the Czech National Bank. The criteria include capital adequacy ratios and the percentage of each bank's non-performing or classified loans. Since, as of March 31, 1997, only funds from the first and second tranches had been used for lending, the participating commercial banks were those originally selected by MUFIS. For the first HG loan MUFIS' board of directors selected nine of the thirteen interested banks as eligible to participate. As of March 31, 1997, the following banks have provided loans to municipalities under the Program: Komerční banka, COOP banka, Pragobanka, and Investični a poštovni banka. Table 1 shows the relative size (out of the total of 61 commercial banks based in the Czech Republic) and the level of program activity of these banks.

Table 1
Actively Participating Banks

Bank	Size in CR*	Number and % of Loans	Amount in Kč(000) and % of Total
Komerční banka	1	8 (29.6 %)	151,990 (29.3 %)
Investični a poštovni banka	3	6 (22.2 %)	78,500 (15.1 %)
Pragobanka	9	6 (22.2 %)	136,000 (26.2 %)
COOP banka	30	7 (26.0 %)	152,653 (29.4 %)
Total		**27**	**519,143**

* Ranked by total assets as of March 31, 1997.

2.03 In anticipation of the third tranche of HG funds (received on March 27, 1997) and as authorized by the amendments to the Program agreement, MUFIS initiated a review of current and potential participating banks aimed at minimizing credit risk to MUFIS and increasing the number of participating banks. As of March 31, 1997, a total of 16 commercial banks had expressed interest in participation in the third tranche of the Program. MUFIS' board is expected to re-sign Master Agreements with some of the currently participating commercial banks and to make its selection of newly participating banks in May and June, 1997 by using similar criteria as for the first round of on-lending.[2]

2.04 The continuing economic transformation of the Czech Republic, as well as recent deterioration in the financial sector, has impacted every sector of the economy, including the banking industry. The Czech Republic had only a few (state) banks in 1990; now there are 61 banks. Competition and occasional insider self-dealing have created difficulties for a number of banks, mostly small to medium-sized banking institutions. As of March 31, 1997 12 banks out of the 61 in the Czech Republic were under specific CNB regulatory measures. Two of them (Credit Bank Pilsen and COOP Bank) were associated with the first tranche program of MUFIS.

2.05 Credit Bank Pilsen, which is currently in bankruptcy, signed a Master Agreement with MUFIS in 1995. However, it did not finance any loans with MUFIS funds and its failure has no impact on MUFIS.

2.06 COOP Bank became a subject of Czech National Bank intervention on April 23, 1996 following its failure to meet CNB's newly imposed limits on capital and reserves adequacy. The CNB's intervention has consisted of limiting shareholder rights and the forced appointment of an administrator to manage the bank. Currently, COOP Bank is seeking a major partner. Prospects for MUFIS to recover the funds it lent to COOP Bank are good even under different scenarios. COOP Bank would qualify for the CNB's program for troubled banks allowing such banks to sell non-performing loans to CNB's subsidiary for 10 years. In addition to that, MUFIS signed an agreement with COOP Bank requiring cession to MUFIS of the loan contracts between the Bank and individual municipalities in case of non-payment. However, COOP Bank has been repaying MUFIS on its seven loans in full and on time.

2.07 **Municipal Bond Purchases.** The amended Program Agreement allows MUFIS to purchase up to 20 percent of a municipality's new bond issue on the primary market, within the standard ceiling limits on loan amounts under the Program. The intention behind the amendment was to encourage MUFIS to support development of the municipal bond market as well as long term bank lending to municipalities. It is contemplated that MUFIS will encourage new institutions to participate

[2] As of May 20, 1997 MUFIS had signed four Master Agreements with Komerční banka (KB), Agrobanka (AGB), Moravia banka, and Česká spořitelna (CS). Agreements with three other banks (CSOB, IPB and Union Bank) were in the final stage of preparation. MUFIS has been negotiating with 7 additional banks out of the 16 expressing interest in the Program.

in bond underwriting by agreeing to purchase part of a bond issue. On March 18, 1997, MUFIS made its first bond purchase of Kč 8 million, representing 20 percent of the total issue of Kč 40 million by the municipality of Zidlochovice. The bond issue was underwritten by Czech and Moravian Guarantee and Development Bank.[3]

2.08 **MUFIS Borrowing.** On March 15, 1995, MUFIS received its first Housing Guaranty (HG) loan of US$20 million. Table 2 provides an overview of HG authorizations and HG loans for the Program.[4]

Table 2
Czech Republic Municipal Infrastructure Finance Program
192-HG-001

Authorization Number	Authorization date	Authorization Amount	Tranche	Obligating Document	Date signed	Amount Disbursed	Date Disbursed
192-HG-001	8/24/93	$10,000,000	1	Letter of Agreement	8/31/93	$10,000,000	3/15/95
192-HG-002	3/04/94	$10,000,000	2	Original ProAg	5/16/94	$10,000,000	3/15/95
192-HG-003	8/6/96	$14,000,000	3	ProAg Amend. #1	8/15/96	$14,000,000	3/27/97
192-HG-004	8/97?	$10,000,000	4	ProAg Amend #2	8/97?		

The shaded boxes indicate the expected information for the upcoming FY 1997 authorization

2.09 After paying one-time fees and charges as specified in the Program Agreement, the initial loan amount was converted into Czech currency at the exchange rate of $1=Kč 25.928, which totaled Kč 509,705,588. The third tranche of US$14 million was received on March 27, 1997. After

3 MUFIS subsequently sent USAID a letter indicating that it viewed the bond purchase as part of its short-term cash management, but requesting authorization to retain the bonds as part of its long-term Program lending. The matter is now pending, while guidelines for bond purchases under the Program are worked out.

4 The terminology regarding HG "tranches" can be confusing to Program participants. Table 2 summarizes HG authorizations from the USAID perspective. Because the first two HG authorizations were combined in a single HG loan, Czech participants often refer to this loan and the on-lending it financed as the "first tranche." For the sake of clarity, this report follows USAID terminology.

paying fees and charges and conversion into Czech currency at the exchange rate of $1=Kč 29.256, receipts totaled Kč 402,749,213 as shown in Table 3.

Table 3
Conversion of HG Tranches

	First and Second Tranches (March 15, 1995)			Third Tranche (March 27,1997)		
	Amount in		Exchange Rate*	Amount in		Exchange Rate*
	$	Kč		$	Kč	
Tranche Amount	20,000,000			14,000,000		
Charges & fees** USAID Initial Fee (1%)	-200,000			-140,000		
Investor Placement Fee	-115,000			-69,000		
2nd Fee to Investor***	0			-8,120		
Paying Agent (RNB)*** - one-time fee	-25,000			-15,000		
Paying Agent (RNB)**** - annual fee	-1,500			-1,500		
Sub-Total	**-341,500**			**-233,620**		
Net Amount Received by MUFIS	**19,658,500**	**509,705,588**	**25.928**	**13,766,380**	**402,749,213**	**29.256**

*   Actual Exchange Rate as of the Date of Conversion
** Withdrawn on payment
*** Interest Rate Round-up
**** Riggs National Bank

2.10 **Disbursement**. As of March 31, 1997, MUFIS had disbursed Kč 519,143,000 in loans and Kč 8,000,000 in purchased municipal bonds, totaling Kč 527,143,000, or approximately 103.4 percent of the total funds initially available from the first two tranches. The additional 3.4 percent represents loans and municipal bonds financed from re-flows. The total corresponds to twenty seven underlying municipal loans and one purchase of municipal bonds. Under the terms of the Program Agreement, "disbursement" occurs at the time MUFIS transfers funds to a participating commercial bank for the purpose of financing an approved municipal loan or at the time of purchase of municipal bonds.

2.11 The transfer of funds to participating banks occurs as follows. The bank sends an application for credit which will be used by a municipality for housing-related infrastructure investment. After conditional loan approval, the participating bank has to submit the following documents to MUFIS:

– valid credit agreement with the municipality
– valid agreement on cession (i.e., a document transferring the underlying municipal loan obligation to MUFIS in the event that the commercial bank fails to make its loan repayments on time).

MUFIS funds are disbursed to participating banks from MUFIS' current account maintained at the Czech and Moravian Guarantee and Development Bank (CMZRB) through the Czech National Bank (CNB) clearing center. All banks in the Czech Republic are electronically connected to this clearing center. MUFIS has to transfer money to the on-lending bank within five working days from the day that MUFIS obtains the two above-mentioned documents. It has met this timetable in all cases. The electronic transfer through CNB does not take more than 24 hours.

2.12 In addition to the 27 loans already approved by MUFIS, as of March 31, 1997 three other municipal loan applications totaling Kč 90 M had been received by banks and were at the final stage of review for municipal creditworthiness and eligibility under MUFIS standards by the individual banks. Table 4 summarizes the number and value of loans submitted to MUFIS for approval.

Table 4
MUFIS Loan Status as of March 31, 1997[5]

Category	No. of Loans	Amount in Kč(000)
Fully Disbursed	27	519,143
Under review by banks	3	90,000
Total	**30**	**609,143**

[5] Since the end of the reporting period, municipal loan demand has escalated. In June 1997, MUFIS indicated that it had received indications from banks of up to Kč 600 million in preliminary loan applications from municipalities.

2.13 During 1995 MUFIS began receiving principal repayments on its outstanding loans from the first and second tranches. Reflows of principal amounted to approximately Kč 41 million in 1995-96 and are projected at Kč 42 million in 1997. So far, MUFIS has financed one loan from reflows in the amount of Kč 10 million in February 1997; it also purchased its share of the Zidlochovice municipal bond from reflows. New lending from reflows is possible because the external HG loans include a grace period of ten years. Thus principal repayments during this period can be used to finance new lending to municipalities. This "revolving fund" aspect of MUFIS will come to an end, under all three tranches, after 10 years. All payments to MUFIS will then be needed to finance MUFIS operations and repay the HG loan.

2.14 Participating commercial banks have disbursed loan amounts to municipalities in different ways. In three cases, the entire amount of approved loan funds was transferred to the municipality, either to a special municipal account or to the municipal general (current) account. The municipality then pays construction costs from these accounts. In this arrangement, the municipality pays interest on the entire loan amount but has the freedom to invest unexpended amounts in income-generating instruments. In most cases, however, banks have retained loan funds under their control until such time as construction related vouchers approved by the municipality are submitted for payment. As a result, disbursements from banks to municipalities are lower than MUFIS disbursement to the banks.

2.15 The total amount of loan funds drawn (used) by municipalities as of March 31, 1997 was Kč 497,143,000 which represents 95.8 percent of all funds owed by commercial banks under the first 26 loan agreements. One municipality (Topolná) had not started to use funds as of March 31, 1997 since it signed its loan contract in February 1997. The first drawdown was scheduled for April 1997.

Table 5
Municipal Drawdown of Loans as of March 31, 1997

Drawdown by Municipalities	No. of Loans	Amount in Kč(000)	% of MUFIS Disbursed Funds
Fully (100 %)	22	399,143	76.9
More than 50 %	4	98,000	18.9
Less than 50 %	0	0	0
Total	**26**	**497,143**	**95.8**
Not used	1*	10	0

* Loan provided on February 28, 1997. First drawdown scheduled for April 1997.

2.16 Physical construction has begun on all of the twenty seven projects where loans have been approved by MUFIS. Even in the abovementioned case of Topolná, which has not drawn upon its MUFIS-approved bank loan, construction has started and is being financed from the municipality's own resources and supplier's credit. One of the conditions of the Program has been that municipalities must submit documentation at the time of loan application demonstrating that they possess all of the necessary building permits for construction. This has narrowed the time between loan approval and project start-up.

2.17 **Loan Negotiations and Loan Administration.** None of the municipalities receiving loans through MUFIS reported major problems or delays in loan negotiation. Some delays in loan authorization have been encountered as a result of the requirement that a municipality obtain all building permits prior to submitting a formal loan application. However, this requirement has speeded the disbursement of funds for approved loans as funds do not sit idle awaiting project permits. On average, the bank loan approval process has taken about 3-4 months from time of initial loan contact by a municipality to final loan approval. Both banks and municipalities reported that the approval process accelerated at the end of the first round of on-lending, as both sides became familiar with program procedures.

2.18 The delay in disbursing the third tranche of the HG interrupted the flow of municipal on-lending. For almost a year, MUFIS did not know when, or whether, it would receive third tranche HG financing. As a result, banks ceased accepting applications for loans that would be eligible for MUFIS financing. This stop-and-go experience not only depleted the loan backlog, slowing disbursement of third tranche financing, but injected a good deal of uncertainty into the program for MUFIS, participating banks, and municipalities.

2.19 Both MUFIS and participating commercial banks have acted efficiently in disbursing funds once a municipal loan application is approved by a bank. On average, the first municipal drawdown of funds occurred 25 days after signing of the loan contract between a municipality and bank. This period includes MUFIS' review and approval of the loan, money transfer from MUFIS to the commercial bank, as well as bank payment to the municipality. The average period between the date a loan was approved by MUFIS and funds were disbursed to the bank was 5-7 days. The principal variable in this period was the time required by banks to submit the necessary documentation for funds disbursement.

2.20 In four cases commercial banks have provided bridge loans to municipalities from their own resources prior to finalizing MUFIS loan agreements.

2.21 Commercial banks providing credit to Czech municipalities formerly required municipalities to switch their main current account to them, or to do other business with them as a condition of the loan agreement. There has been significant change in this regard, partly as a result of competition under the MUFIS program. Eleven municipal loans involved lending from the municipality's main banking institution, while sixteen loans involved lending from other than the main banking institution. Out of these 16 loans:

(a) four municipalities were required to switch their general current account to the bank providing the MUFIS loan

(b) three were required to open a special account for the whole project including financing coming from other than MUFIS sources

(c) nine were required to establish an account for MUFIS funds only for the purpose of recording usage of the funds. In these cases the banks reserved the right to access the municipal current account (from a different bank) in case of default.

2.22 **Administration of Bond Purchases**. MUFIS' entry into the primary bond market raises a new set of issues for the institution. Up to now, MUFIS has served as a financial intermediary. Its lending risk has been mitigated by lending to financial institutions which are obligated to repay their MUFIS loans whether or not they are paid by the final municipal borrower.

2.23 By purchasing municipal bonds, MUFIS becomes directly exposed to municipal credit risk. At the time this report was prepared, MUFIS had no administrative procedures spelling out how potential bond purchases should be evaluated, how municipal credit risk should be assessed, or how bond purchases should be approved internally. No information had been provided to participating banks at large on the availability of MUFIS funds to support bond underwriting, and no administrative procedures had been established for working with banks or other financial institutions which desired to use MUFIS funds for this purpose.

2.24 MUFIS does not presently have the capacity to assess municipal credit risk on its own. It is not clear whether CMZRB possesses this capacity, or whether assessment of municipal credit risk can generally be covered by MUFIS' management agreement with CMZRB. In cases where MUFIS purchases municipal bonds underwritten by CMZRB, it would require an independent evaluation of the risks and benefits of bond purchase.

2.25 In addition, bond purchases raise several distinctive issues that do not arise in the case of commercial bank loans to municipalities. First, the investment purpose often is not identified in a bond prospectus, or is described so broadly that it is not clear what proportion of the investment would count as "eligible expenditures" under the HG program rules. Second, the maturity of a bond issue may not fall within the presently allowable time limits for municipal lending under the Program agreement (seven to fifteen years). Third, as in the case of MUFIS' first bond purchase, the interest rate may exceed program guidelines for municipal loans.

2.26 All of these factors make it an urgent priority that USAID, MUFIS, and the Ministry of Finance agree on written procedures to govern MUFIS' future participation in the primary municipal bond market. Clarification of procedures also is important to identify what constitutes "short-term, cash-flow" investments and long-term Program lending. MUFIS appears to have viewed its purchase of the 10 year idlochovice bond at the time of issue as a "short-term" purchase which did not have to meet Program standards for municipal lending.

2.27 **Future Disbursement**. As of March 31, 1997, MUFIS had fully disbursed the US$20 million from the first two tranches and just received (March 27, 1997) the US$14 million of the third tranche. MUFIS now expects to place at least 70 percent of the third tranche funds (or about Kč 280 million) in 1997. MUFIS plans to place the remaining available funds from the third tranche and from reflows during the first quarter of 1998.

2.28 In the past, MUFIS has been overly optimistic in projecting disbursement rates. At the time of the first HG borrowing, MUFIS requested approval to borrow the full authorized amount of US$20 million at one time, because it foresaw the ability to disburse funds rapidly. MUFIS' original projections, made in January of 1995, were that funds from the first borrowing would be fully disbursed within 2.5 months of receipt. This estimate was based upon banks' expressed demand for funds, which MUFIS accepted at face value.

2.29 At the time of the first interim evaluation (July, 1995) MUFIS estimated that 100 percent disbursement would be reached by the end of October 1995. In actuality, funds were not fully disbursed until June 1996.

2.30 Despite the slower than originally anticipated disbursement pace, the disbursement record of the first borrowing compares very favorably with the norm under Housing Guaranty programs worldwide. Roughly 90 percent of the $20 million HG first borrowing was disbursed within nine months. Banks and municipalities appear to have familiarized themselves with the structure of the program, with the result that the loan application process was reported by all parties to be going smoothly.

2.31 Future demand for MUFIS funds remains positive. Throughout 1996, long-term interest rates in the Czech domestic market remained relatively stable at rates comparable to MUFIS loans. The domestic credit market has tightened considerably in 1997, making MUFIS loan rates more attractive. Some of the banks participating in the MUFIS program have developed special relations with regional municipalities and have aggressively marketed the advantages of long-term credits. All in all, MUFIS' current projection of municipal loan demand seems more conservative than in the past.

2.32 At this point, the greatest uncertainty surrounding MUFIS' future on-lending concerns the availability, magnitude, and timing of future HG tranches. MUFIS requested a third tranche of $20 million in 1995. It believed that the borrowing process would take time, but that funds would be available for the spring 1996 construction season. USAID-Washington originally agreed to a third tranche of $10 million, then later increased the amount to $14 million. However, HG disbursement was held up and funds were received by MUFIS one year later than originally anticipated. Both MUFIS and participating banks were reluctant to activate municipal demand for funds during 1996 because of the uncertainty of when (or if) funds would be available, and the fear of generating demand for long-term credits that could not otherwise be satisfied. This hiatus in funding threatened to jeopardize overall program operations, by leaving the impression that MUFIS was not a reliable or predictable source of financing.

2.33 **Loan Repayments.**

A. Repayments from MUFIS to U.S. investors:

Interest payments to U.S. investors for both HG loans are due semi-annually on March 15, and September 15 of each year. As of March 31, 1997, MUFIS had made all of its payments of interest and periodic fees in full and on time as indicated in Table 6. All repayments correspond to the first HG loan. The exchange rate of the first payment due on September 15, 1995, was $1.00 = Kč 27.05, reflecting a decline of 4.3 percent in the value of the crown from the date of borrowing. Similarly, other repayments reflect the fluctuation and declining trend in the value of the Czech crown from the date of borrowing. The first repayment of principal on the first HG loan is not due until 2005, after the 10-year grace period. Repayment of principal of the second loan commences in 2007 after the 10-year grace period.

Table 6
Repayments from MUFIS to U.S. Investors as of March 31, 1997

Date Due	Date of Payment Order	Amount in $ (thousand)			Exchange Rate	Amount in Kč (thousand)		
		Interest	Fee			Interest	Fee	
			USAID	RNB			USAID	RNB
September 15, 1995	September 6, 1995	836.0	50.0	-	27.048	22,612.1	1,352.4	-
March 15, 1996	March 8, 1996	836.0	50.0	1.5	27.245	22,776.8	1,362.3	34.2
September 15, 1996	September 4, 1996	836.0	50.0	-	26.090	21,811.2	1,304.5	-
March 15, 1997	March 7, 1997	836.0	50.0	1.5	29.535	24,691.3	1,476.8	37.0
Total		3,344.0	200.0	3.0		91,891.4	5,495.9	71.2

B. Repayments from commercial banks to MUFIS:

Commercial banks repay interest to MUFIS quarterly (March 31, June 30, September 30, and December 31) and twice a year pay loan principal (June 30, and December 31). As of March 31, 1997, banks had paid to MUFIS a total of Kč 74,569,377 in interest payments and Kč 40,661,282 in principal repayments on 24 loans. [Table 7.] All interest and principal payments by commercial banks to MUFIS were made in full and on time. From the 27 loans provided to date, MUFIS will receive in 1997 approximately Kč 79 million in interest and principal payments. The portion of these funds corresponding to payments of principal will be available for re-lending.

Table 7
Repayments from Commercial Banks to MUFIS in Year Ending March 31, 1997

Bank	**Loan Repayments**	
	Number of Loans	**Amount (Principal) in Kč**
Komerční banka	8	14,574,100
Investični a poštovni banka	6	9,168,800
Pragobanka	6	8,066,082
COOP Banka	7	8,852,300
Total	27	40,661,282

C. Repayments from municipalities to commercial banks:

The repayment schedule for individual loans to municipalities is subject to negotiation between a given bank and a municipality. The frequency of payments varies case by case for both interest and principal.

(i) Repayments of principal:

Arrangements range from two principal payments per year (10 loans), to quarterly payments (15 loans) to monthly repayment (2 loans). Most common are equal principal installments (21 loans). In some cases the amount of principal repayment changes over time (6 loans); typically, this involves increasing principal payments so as to maintain fixed total payments (principal plus interest). There has been only one case--City of Trebic--in which a commercial bank agreed to grant a grace period on principal repayment as part of the original loan terms. City of Trebic negotiated this arrangement with COOP Bank based on the planned construction progress of its project and the expected stream of project revenues.

(ii) Interest payments:

Municipalities pay interest to commercial banks either quarterly (14 loans) or monthly (13 loans). Interest due is calculated from the actual amount of the loan that has been drawn. Interest payments by municipalities totaled Kč 61,358,000 as of March 31, 1997. This is approximately Kč 13.2 million less than the commercial banks had to pay MUFIS, since banks have the obligation to pay interest to MUFIS on the whole amount of the loan beginning from the date of transfer of funds from MUFIS to a bank. (The bank is free to invest undisbursed funds in short-term money instruments.)

2.34 Bank payments to MUFIS are handled in reverse order from MUFIS disbursements. Payment of interest and principal have to be received within five working days of the scheduled due date. Transfers are made from the account of a participating bank through the CNB clearing center to MUFIS' general current account at CMZRB.

III. MUNICIPAL BORROWING AND MUNICIPAL INVESTMENTS

3.01 **Underlying Municipal Loans and Project Investments**. As part of the monitoring, the consulting team investigated the loan arrangements between lending banks and borrowing municipalities, as well as the underlying municipal investment projects, for the 27 loans that had been disbursed by MUFIS as of March 31, 1997.

3.02 For each of the 27 loans, one or more members of the assessment team visited the borrowing municipality and interviewed the mayor, other key members of the municipal administrative staff, including budget officers and those responsible for implementing the investment project, and, in most cases, loan officers of the branch of the bank responsible for loan negotiations with the municipality.

3.03 The tables and comments below provide an overview of the investment projects that are being financed through MUFIS loan activity. Annex A describes the individual loans and investment projects.

3.04 **Size of Borrowing Municipality**. MUFIS funds have been used by participating banks to finance loans primarily for small and medium-sized municipalities. This is consistent with program objectives. The few large cities in the Czech Republic have access to the credit market without the intermediation of MUFIS. A principal rationale for the development of MUFIS was to increase credit availability for the great bulk of municipalities, which have populations under 10,000. [Only 284 of the 6,232 municipalities in the Czech Republic have a population over 5,000]. Table 8 provides a breakdown of loan activity by municipal population size.

Table 8
MUFIS Loans by Municipal Population

Population Size	Number of Loans		Total Amount	
	No. of Loans	in %	in Kč(000)	in %
Less than 5,000	11	40.7	132,500	25.5
5,000-10,000	10	37.0	258,360	49.8
10,000-20,000	2	7.4	36,783	7.1
20,000-50,000	2	7.4	47,000	9.0
50,000-100,000	2	7.4	44,500	8.6
100,000 and over	0	0.00	0.00	0.00
Total	**27**	**100.0**	**519,143**	**100.0**

3.05 **Regional Distribution**. Loans have been distributed throughout the entire country. Table 9 shows the distribution between Bohemia and Moravia-Silesia. The Program Agreement stipulates that a minimum of 75 percent of loan activity will take place outside of Prague. To date all twenty seven MUFIS loans have been made outside of the City of Prague. (Note that the demarcation between Moravia and Silesia is not completely clear, because "regions" are not legally defined in the Czech Republic. However, by conventional regional groupings, 7 loans have gone to Bohemia, 12 to Moravia, and 8 to Silesia.)

Table 9
MUFIS Loans by Region

By Region	Number of Loans		Total Amount	
	No. of Loans	in %	in Kč(000)	in %
Bohemia	7	25.9	162,990	31.4
Moravia-Silesia	20	74.1	356,153	68.6
Total	**27**	**100.0**	**519,143**	**100.0**

3.06 **Loan Maturity**. The Program Implementation Plan allows loans ranging from 7 to 15 year maturity. Table 9 shows that the loans made so far have been at the longer end of the maturity options. Fourteen of the twenty seven loans representing 67 percent of the disbursed loan amount have been for 14-15 years, the longest period allowed under the Program Implementation Plan. These MUFIS loans are the longest-term municipal loans that have been made in the Czech Republic. They directly support the program objective of lengthening municipal lending periods, in order to provide a more stable and more affordable basis for infrastructure financing. As shown in Table 10, another group of eleven loans (or 29 percent of total lending) was provided for 10-11 years. This type of maturity is still very scarce in the Czech Republic.

Table 10
MUFIS Loans by Maturity

By Maturity	Number of Loans		Total Amount	
	No. of Loans	**in %**	**in Kč(000)**	**in %**
Less than 10 years	2	7.4	21,000	4.1
10-11 years	11	40.7	150,653	29.0
12-13 years	0	0.0	0	0.0
14-15 years	14	51.9	347,490	66.9
Total	**27**	**100.0**	**519,143**	**100.0**

3.07 **Interest Rates**. MUFIS rules place a ceiling of 2.5 percentage points on the margin that banks can add to their cost of capital from MUFIS in municipal lending. Banks borrow funds from MUFIS at 9.5 percent. The ceiling rate for on-lending therefore is 12 percent. As can be seen from Table 11, all loans have been within this ceiling. Competition between banks has resulted in many loans and more than half of the approved lending amount being made at rates below the authorized ceiling. This is one of the benefits of using MUFIS to encourage competition among potential lenders. Bigger cities were more likely to receive interest rates below the ceiling. For example, two of the three 11 percent loans were made to the two largest cities in the program, Pardubice and Opava.

Table 11
MUFIS Loans by Interest Rate

Interest Rate	Number of Loans		Total Amount	
	No. of Loans	in %	in Kč(000)	in %
11%	3	11.1	58,500	11.3
11.5%	9	33.3	195,153	37.6
11.75%	1	3.7	25,000	4.8
12%	14	51.9	240,490	46.3
Total	**27**	**100.00**	**519,143**	**100.00**

3.08 MUFIS appears to have interpreted the ceiling rate restrictions as not applying to its own purchase of municipal bonds, or to have interpreted its bond purchase as a short-term cash investment. The bond issue MUFIS purchased carries an interest rate of 12.9 percent, and a margin of 3.4 percent over MUFIS' on-lending rate to banks. Whether this interpretation of the on-lending limitations is consistent with USAID's intent in the Program Agreement is unclear and should be resolved, along with other procedures to be followed in the case of bond purchases.

3.09 **Type of Collateral**. One of the program objectives has been to encourage banks to move away from exclusive reliance on municipal property as collateral for municipal loans. Heavy reliance on property collateral (i) limits municipal use of credit since a municipality´s borrowing capacity is constrained by its tangible property holdings; (ii) restricts a municipality´s economic development and other options since property offered as collateral cannot be sold to third parties and cannot be modified without bank approval; and (iii) diverts attention from the most important factor in municipal ability to pay--the adequacy of future income streams to service debt obligations.

3.10 Formally, legal dedication of future revenue streams as collateral for debt repayment is not possible under Czech law, which recognizes only currently owned assets as possible collateral. A municipality can promise to repay loans from specific future revenues, but the contract is not enforceable in the Czech courts--i.e., it would not be possible for the creditor to seize future revenue streams in the event of non-payment. This provision of Czech law makes strict "revenue bond" financing impossible. Lenders have sought to circumvent this restriction by writing loan contracts that give a bank the right to foreclose on a municipality's current account--an existing asset that can be offered as collateral--up to the amount of annual property tax receipts or up to the amount of personal income tax allocations. Where "future revenues" are indicated as collateral in Table 11, they refer to this indirect collateralization of the current account, up to sums that correspond to some annual revenue amount. Since there have been no cases of default on municipal loans or municipal bonds in the Czech Republic, the exact position the courts would take on different types of commitments contained in loan documents in the event of default remains unclear.

3.11 Table 12 shows the principal security behind MUFIS loans. Thirteen of the 27 loans have been secured in whole or in part by municipal real property. Prior to 1995, essentially all municipal loans in the Czech Republic were secured by property collateral. Promissory notes are now one of the most common forms of collateral. These represent signed notes, prepared in advance by the municipality, dated to coincide with each loan installment due date, which the lending bank can cash in the event that loan payments are not received in a timely manner. Future revenues are used indirectly as collateral in 10 cases, despite the legal hurdles to revenue bond financing.

Table 12
MUFIS Loans by Type of Collateral

Type of Collateral	Number of Loans		Total Amount	
	No. of Loans	in %	in Kč (000)	in %
Promissory Notes*	6	22.2	132,000	25.4
Municipal Property	6	22.2	117,990	22.7
Future Revenues	2	7.4	30,153	5.8
Financial Assets	1	3.7	22,000	4.2
Combination: Promissory Notes + Mun. Property	1	3.7	19,000	3.7
Combination: Promissory Notes + Fut. Revenues	4	14.8	40,500	7.8
Combination: Promissory Notes + Mun. Property + Fut. Revenues	3	11.1	65,000	12.5
Combination: Promissory Notes + Cur. Account**	1	3.7	22,500	4.3
Combination: Promissory Notes + Current Account** + Mun. Property	1	3.7	18,000	3.5
Combination: Mun. Property + Fut. Revenues	1	3.7	40,000	7.7
Combination: Mun. Property + Fin. Assets	1	3.7	12,000	2.3
Total	**27**	**100.0**	**519,143**	**100.0**

* The bank receives advance-dated notes that it can cash in the event it does not receive timely payment from the municipality. A note is provided for each due date of interest or principal.

** The bank has the right to claim funds held in the municipal current account in the event of default.

3.12 **Debt Service Ratios.** One of the most important measures of municipal indebtedness is the debt service ratio, defined as the ratio of annual interest and principal payments on debt to total municipal expenditures.[6] A high ratio suggests that a municipality has relatively little budgetary flexibility. Municipalities in the Czech Republic are not restricted in their borrowing by any state laws. However, a significant debate has arisen during the last year as to whether some Czech municipalities have placed themselves at risk by taking on "excessive debt" in their borrowing and whether the state should act to limit local borrowing.

3.13 Data on municipal debt obligations and municipal debt service are not readily available. There is no mandatory reporting of this information. Municipalities in the Czech Republic are reluctant to disclose data in general. For this study the authors gathered original information concerning not only MUFIS loans but all of the municipal debts outstanding and the payment schedule for each of them for all 26 municipalities and the 27 municipal loans involved in the MUFIS program. Data were obtained by both telephone and personal interviews with mayors and municipal finance directors. Local responses were cross-checked from other sources. All possible sources of municipal borrowing were identified, both from subsidized state sources and commercial sources. Respondents were asked to confirm in writing the magnitude of debt service paid in 1996 under each type of loan.

3.14 The authors believe that the data reported and the debt service ratios shown in Table 13 are accurate. The debt service obligations are significantly higher than those indicated in the 1996 Program Monitoring Report for the following reasons: a) the 1996 Monitoring Report, prepared in May, 1996, reflected actual debt service obligations during the year 1995. Since most of MUFIS' loans were provided in the second half of 1995, payments of principal on these loans were not due until 1996. Similarly, b) loans that were in their grace period, interest free loans from the State Environmental Fund and other subsidized loans from governmental agencies, did not represent a current debt service burden for 1995.

3.15 The data shown in Table 13 also differ in some aspects from those calculated in a similar study, "Debt Burdens of Municipalities Using MUFIS Loans" conducted in the second half of 1996. The debt service ratios presented in Table 13 of this report have been calculated based on actual total expenditures for 1996 and actual debt repayments paid in 1996 by each municipality, while the above-mentioned report, "Debt Burdens..." used 1996 budgeted expenditures and projected debt service. Often, municipalities are intentionally conservative in estimating revenues for budget purposes; when

6 A debt service ratio normally is defined as the ratio of debt service to revenue, preferably recurring revenue. However, in the Czech Republic recurring revenues are not accounted for separately from extraordinary revenues, including the "revenue" received from long- and short-term borrowing and the proceeds of asset sales. Under these circumstances, expenditures provide a better normalized indicator of budget level. (See Table 21 for a comparison of aggregate debt service/revenue and debt service/expenditure ratios.)

Table 13
Annual Debt Service for Borrowers under MUFIS Program--1996

Municipality	Budget Total Expenditures (in ths. Kč)	Share from Budget Expenditures (in %)						
		MUFIS	Commer. Loan	SEF	MOF	District Office	Other Sources	Total
Vratimov *	123,284.000	7.83	1.13	0.75				9.7
Bučovice	81,329.659	3.24				9.22	1.23	13.7
Bruntál	214,163.363	0.77	5.20					6.0
Opava	567,856.520	0,70	3.60	0.03				4.3
Jablùnka	19,722.350	10.78	3.18					14.0
Byst ička	5,839.000	34.15						34.2
T ebíč	419,956.000	0.96	5.06					6.0
Vítkov	52,691.240	3.99		0.93				4.9
Kralupy n. Vltavou	226,388.750	2.25	3.91					6.2
Svatava	22,698.440	7.95	8.53	3.58		14.32		34.4
Frýdlant	92.024.156	8.08		1.28				9.4
Dolní Domaslavice	13,809.452	3.59						3.6
Pardubice	854,623.222	0.56	2.07				1.09	3.7
Slavicín	107,350.000	0.88						0.9
Topolná	6,500.000							0.0
Nýdek	21,713.000	12.65					3.37	16.0
Dolní Kounice	29,594.190	3.55						3.6
Ledeč n. Sázavou	53,917.000	6.80	10.40					17.2
Velké Losiny	62,624.000	6.55						6.6
Bystřice p. Hostýnem	13,417.446	4.01						4.0
Jesenice	33,753.148	9.20		2.22				11.4
Slavkov u Opavy	19,682.212	21.05						21.1
Blansko	176,644.784	0.97	0.81	0.56	0.51		1.08	3.9
Slavkov u Brna	57,621.683	5.66						5.7
Prùhonice	56,240.262	4.93	4.93					9.9
Mikulovice	34,554.000	5.12		1.74			0.27	7.1

* Vratimov has two MUFIS loans:
1. 6.01 % share from budget expenditures
2. 1.82 % share from budget expenditures

higher revenues materialize, expenditures also increase and the debt service ratio will fall (because debt service is fixed).

3.16 By international standards, some of the debt service ratios in Table 13 are very high. Normally, a debt service ratio in excess of 15 percent is considered to be a red flag requiring further examination. Five of the 26 MUFIS municipalities had debt service ratios in excess of 15 percent in 1996. Two of the municipalities paid more than 34 percent of their total budget expenditures for debt service. These high levels of debt burden do not necessarily point to a financial problem. A municipality may choose to emphasize capital construction during a period and knowingly accept the consequences of high debt service. No municipality has missed or been late in a MUFIS debt payment. Nevertheless, the situation requires careful monitoring. This is particularly true of a municipality like Svatava, which has borrowed from a variety of different sources including the MUFIS program, a pure commercial loan, the State Environmental Fund, and the District Office. It is tempting in these circumstances to shift debt around until the municipality finds a lender willing to tolerate non-payment or re-scheduling. The appropriate question for future monitoring is not only whether MUFIS payments are made on time, but whether MUFIS borrowers are making all of their debt service payments to all lenders on time.

3.17 **Municipal Investment Projects**. MUFIS loans have been used for a wide variety of project purposes. Municipalities have covered all or part of the financing of 41 separate projects from 27 loans and one municipal bond. Table 14 summarizes the principal investment activities being financed. However, some of the loans are being used for related investment projects, making a strict classification of loan purpose difficult (e.g., “comprehensive reconstruction”). Environmental investments loom large in the overall financing picture. Given the large backlog of local environmental needs, this use of MUFIS funds would appear to fit national priorities. Most of the projects have a positive environmental impact. In some cases the projects’ impact on pollution reduction is directly measurable (waste water treatment, sewer systems); in other cases the effects are more indirect (energy savings from building insulation or installation of metering devices).

3.18 The impact of projects on the local population is illustrated by Table 15. In all, the projects serve more than 42,000 households with a population of more than 142,000 people, all living outside of the city of Prague. The water, sewer, and landfill projects serve essentially the entire local populations. Other projects have concentrated on re-building portions of a town, or providing more energy-efficient heating for clusters of individual housing projects.

Table 14
Municipal Projects Financed with MUFIS Loans

Primary Purpose	Number of Projects		Total Loan Amount	
	No. of Building Permits	in %	in Kč (000)	in %
Metering and Control Devices (heating)	3	7.3	33,653.00	6.5
Water Distribution	4	9.8	31,586.00	6.1
Sewer Collection	9	22.0	114,019.50	22.0
Comprehensive Infrastructure Reconstruction	6	14.6	75,908.00	14.6
Gas Distribution and Energy Conversion*	12	29.3	99,735.25	19.2
Co-Generation for Residential Heating	4	9.8	125,360.00	24.2
Solid Waste Landfill	2	4.9	20,881.25	4.0
Building Insulation	1	2.4	18,000.00	3.5
Total	**41**	**100.0**	**519,143.00**	**100.0**

* Conversion from coal to natural gas heating.

3.19 **Project Cost Recovery**. The Program has the objective of encouraging cost recovery in municipal investment projects--i.e., the recovery of at least a significant portion of project investment costs through fees and charges levied on users or beneficiaries. This kind of pricing reduces the pressure of borrowing on the overall municipal budget, makes possible a higher level of local investment activity, and apportions costs to those who benefit most substantially from project investment. Of course, full cost recovery from users is inappropriate in many cases. In particular, environmental projects often produce area-wide benefits that make them appropriate to finance in part through general tax revenues or central government subsidies.

Table 15
Households Benefiting from Projects

Project Type	Number of House-holds Benefiting	Population Benefiting	% of Total Municipal Population Benefiting
Metering and Control Devices (heating)	5,953	18,954	21
Water Distribution	1,920	5,838	38
Sewer Collection and Treatment	9,563	28,150	20
Comprehensive Infrastructure Reconstruction	5,445	22,135	13
Gas Distribution and Energy Conversion	5,070	15,749	33*
Co-generation for Residential Heating	1,654	5,914	41
Solid Waste Landfill	11,900	43,000	100+*
Building Insulation	712	2,322	13
Total	**42,217**	**142,062**	**-**

* Two projects of this category serve neighboring municipalities

3.20 Municipalities have been most likely to recover part of their investment costs through user fees when the utility system that owns the property has been completely turned over to municipal ownership. Otherwise, the municipality does not fully control fee-setting, and it may not receive any financial benefits from higher fees. This arrangement discourages direct linkage of cost recovery pricing to municipal investment. Full cost recovery has been most common on projects involving the installation of metering devices. Investments in landfills, water and wastewater projects also show a significant percentage of cost recovery. Heating conversion projects and projects to extend gas distribution lines provide mostly environmental benefits. They have had a low rate of direct cost recovery, or none at all.

3.21 Table 16 shows the estimated cost recovery rate for projects financed by the 27 MUFIS loans. In most cases city officials have made projections of future operating costs as well as future project revenues, permitting calculation of the extent of planned recovery of investment costs. The cost recovery estimation period has been somewhat arbitrarily limited to eight years. Projections of costs and revenues beyond that span are inherently uncertain.

3.22 Overall, Table 16 shows a relatively low level of cost recovery on MUFIS projects. Why? Part of the explanation is that Czech municipalities until 1996 enjoyed robust growth from general revenues. As a group, they have been able to finance rising investment shares and still maintain balanced budgets. They have not faced significant fiscal pressure to recover capital costs in order to sustain investment levels. This situation, however, changed toward the end of 1996 and in 1997. As a result of the new fiscal pressure on municipalities, it is likely that more attention will be given to cost recovery on capital projects in the future.

3.23 There also has been intense citizen opposition to fee increases. Fees for water service, wastewater collection and treatment, and residential heating already have risen at very steep rates because of price deregulation. Municipal authorities have been reluctant to add capital cost recovery to the fee structure. Finally, institutional arrangements weaken the incentives municipalities might otherwise have to raise fees. Gas distribution, for example, is provided by an independent company. The gas company collects all charges. A special arrangement would have to be negotiated to include in the gas bill a fee that repays the municipality for the capital costs incurred in extending gas lines. A similar situation is found in many regional water companies. These are owned collectively by a number of municipalities, and serve a regional customer base. Special arrangements have to be negotiated for a single municipality to recover through water tariffs the capital costs incurred to upgrade or extend the local water distribution system.

Table 16
Estimated Capital Cost Recovery on MUFIS Projects

Estimated Project Cost Recovery over 8 Years of Operations	Number of Loans	Total Value in Kč (000)	%
0 %	7	117,000.	22.5
1 - 25 %	8	129,500.	24.9
26 - 50 %	6	113,130.	21.8
51 - 75 %	2	57,360.	11.1
76 - 100 %	4	102,153.	19.7
Total	**27**	**519,143.**	**100.0**

3.24 **Sources of Project Financing.** Most municipalities are using more than one source of financing for their infrastructure projects. Given the complexity and interconnections within the systems of municipal infrastructure, it is often difficult to determine if a given construction is part of a bigger project or if it should be viewed as a stand-alone project. Consequently, it can be difficult to isolate the MUFIS share of overall project financing. In addition to MUFIS loans, 15 projects were financed by municipal own-resources in the range of 5 to 30 percent of construction costs. The State Environmental Fund co-financed eight projects, and the Ministry of Agriculture co-financed four projects. The Ministry of Finance and Ministry of Culture co-financed one project each. In three cases, a group or association of municipalities complemented the MUFIS loan with own resources. In one case, the MUFIS loan was supported by additional financing from the local business community.

IV. INSTITUTIONAL CAPACITY OF MUFIS AND ITS FUTURE ROLE IN THE MUNICIPAL CREDIT MARKET

4.01 The overall goal of the Municipal Infrastructure Finance Program has been the creation or strengthening of institutional capacity throughout the municipal credit market. The technical assistance strategy for training commercial banks in credit analysis, and collaborating with Parliament and government ministries on policy reforms, has been described in other reports. This report examines the institutional capacity of the Municipal Finance Company, MUFIS.

4.02 **MUFIS--Municipal Finance Company.** Based on authorization by the Czech Government represented by the Ministry of Finance (MoF), MUFIS was founded by the Czech and Moravian Guaranty and Development Bank (CMZRB) with an initial capital of Kč 1 million and registered as a joint stock company according to the Czech Commercial Code in April, 1994. Subsequently, the shares were transferred in March 1995 to reflect MUFIS' current ownership. Major shareholders are MoF and CMZRB which own 49 percent each. The third shareholder is the Union of Towns and Communities (UTC) of the Czech Republic which owns the remaining 2 percent. Upon registration, MUFIS became the bearer of guaranties provided by the Czech Government. The Government has authorized guaranties for up to $100 million of HG loans, subject to implementation by the Minister of Finance.

4.03 MUFIS has a Board of Directors which oversees administration, and a Supervisory Board, which sets policy. The boards consist of representatives from MoF, CMZRB, UTC, the Ministry of Regional Development, and municipal governments, as well as independent experts on municipal finance.

4.04 MUFIS' role in a broad sense is to support development of a self-sustaining, market-based credit system to finance municipal infrastructure in the Czech Republic, as specified in the Policy Action Plan of the Program Agreement. The role of MUFIS in a narrower sense with respect to HG funds is threefold: (a) to solicit and receive funds from U.S. investors who are guaranteed by USAID under its Housing Guaranty Program, (b) to make loans to participating financial institutions which on-lend to municipalities for eligible infrastructure projects, (c) to purchase a portion of municipalities' bond issues. MUFIS thus is a specialized financial intermediary. Its role is illustrated in Figure 1.

4.05 **MUFIS' Financial Operations.** MUFIS started financial operations in March, 1995 by receiving $20 million as the initial HG Loan, followed by second HG loan of $14 million received in March 1997. Its financial operations have included: (a) receiving and converting into Czech currency both loans of $20 and $14 million; (b) payment of interest on the first tranche to the U.S. investor on September 15, 1995, March 15, 1996, September 15, 1996 and March 15, 1997; (c) disbursing funds by providing loans to participating commercial banks; (d) purchasing municipal

bonds; (e) receiving payments of interest and repayments of principal from participating commercial banks, (f) management and placement of undisbursed funds.

4.06 MUFIS' fiscal year, according to the legal requirements of the Accounting Law, corresponds to a calendar year starting January 1 and ending December 31. MUFIS' Profit and Loss Statement for 1996 [Table 17] indicates a loss in the amount of Kč 2.05 million. This is significantly less than the Kč 11.9 million loss reported in 1995. Before transfers to reserves, MUFIS almost broke even on an operating basis in 1996. It incurred less than a Kč 400,000 (U.S. $13,000) loss.

Table 17
1996 Profit and Loss Statement of MUFIS, Inc.

Item	**1996 Expenses**	**Kč(000)**
1	One time fees and charges on loan delivery (allocated over 5 years)	308
2	Periodic charges to USAID and Riggs National Bank	2,710
3	Interest payments to U.S. investor	44,624
4	Charges for services of external companies	1,226
4a	of which: auditor	(100)
4b	accounting company	(176)
4c	CMZRB	(945)
5	Other expenses	287
6	Allocation to foreign exchange loss fund	1,183
7	Allocation to cash-flow risk fund	473
8	**Total Expenses**	**50,811**
	1996 Revenues	
9	Interest on short-term financial investment (after 25%withholding tax)	1,332
10	Interest on provided credits (not subject to withholding tax)	44,944
11	Interest on bank current account (not subject to withholding tax)	2,459
12	Other revenues	24
13	**Total Revenues**	**48,759**
14	**Profit / Loss of Current Year**	**-2,052**

4.07 MUFIS' losses for 1995 were partially offset by resources drawn from the foreign exchange reserve fund and cash flow reserve fund, which totaled Kč 0.4 million. The state budget contributed Kč 2.2 million based on an agreement signed between MUFIS and MoF during 1996 to cover currency exchange losses beyond MUFIS' reserve provisioning. The total net loss for 1995 of Kč 9.3 million was carried forward to 1996.

4.08 MUFIS' economic performance stabilized in 1996. Closer supervision by the MUFIS Boards and better financial management by CMZRB led to the better financial results. For example, MUFIS' short-term cash deposits were shifted to financial instruments that do not require tax withholding--an important factor for an organization like MUFIS which has a net loss position and therefore is not subject to profits tax.[7] The Supervisory Board approved MUFIS' financial statements for 1996 on May 20, 1997 and approved a proposal to the general shareholders meeting regarding partially offsetting the cumulative loss as shown in Table 18.

Table 18
Proposal for Balancing MUFIS Loss

Item	**Kč (000)**
Economic Result (Profit/Loss) from Current Year	-2,052
Unpaid Loss from Previous Years	-9,258
Transfer from Foreign Exchange Loss Fund	1,183
Transfer from Cash Flow Risk Fund	473
Subsidy from MOF for Foreign Exchange Losses	2,970
Unpaid Loss Balance for 1997	-6,684

4.09 The major factors contributing to the 1996 loss were:

– Exchange rate losses: unfavorable exchange rate movements increased MUFIS' HG loan repayments in Czech crowns.

[7] In the Czech Republic, tax withholding on interest cannot be recaptured by businesses like MUFIS that have operating losses.

- Cost of services provided to MUFIS by CMZRB increased by approximately 0.7 million to a total of Kč 0.945 million. The basis for calculating CMZRB's fee is 0.2 percent assessed on the amount of outstanding principal on loans provided to commercial banks.

- Higher allocation to reserve funds in 1996. MUFIS' ability to fund reserves should be viewed as a positive step. The exchange rate reserve fund is being allocated 0.25 percent and the cash flow reserve fund 0.1 percent of the outstanding principal on loans provided to commercial banks.

4.10 Overall, MUFIS revealed an improved capacity for financial management in its second year. Its management of undisbursed funds through short-term investments has improved. Agreement was reached with CMZRB to the effect that MUFIS' current account balance would earn interest at a rate of 1 percent below PRIBOR rate. Interest earnings from current accounts are not subject to income withholding tax.

4.11 The Supervisory Board, responsible for setting MUFIS' policy, including guidelines for financial operation, held eight meetings in 1996. The Board formulated a clear policy statement regarding cash management as recommended in the 1996 Monitoring Report. This approach resulted in the above-mentioned arrangement with CMZRB, which structures the interest rate of MUFIS' current account as a floating rate tied to PRIBOR. Other instruments used by MUFIS for short-term investments included state bonds (not subject to withholding tax) and Komerční banka (KB) bonds. Fixed time deposits and deposit certificates (both subject to 25 percent withholding tax) have been phased out.

4.12 MUFIS did not accept USAID's technical assistance recommendations to create full-time administrative positions in cash management and accounting. One reason is the cost of full-time positions. CMZRB personnel have performed the cash management functions described above as part of CMZRB's management agreement.

4.13 Looking to the future, MUFIS' spread on the initial HG funds, even when these are fully lent to participating banks, is slim. As shown in Figure 1, the difference between MUFIS' cost of funds and its on-lending rate was only 0.44 percent for the first HG loan, excluding potential foreign exchange losses. The Ministry of Finance has agreed to absorb the cost of foreign exchange losses beyond the 0.25 percent reserve provisioning. However, MUFIS must pay for all its operating costs from the spread. A spread of 0.44 percent, applied to a $100 million loan portfolio, would generate $440,000 per year of income, more than ample to cover MUFIS' operating costs. However, the same spread applied to a portfolio of $20 million generates only $88,000 potential income.

4.14 The second HG borrowing took place in March 1997, under somewhat more favorable conditions, and provides MUFIS with more flexibility to generate income to cover its operating expenses. MUFIS' cost of funds totaled 8.31 percent in U.S. dollars, which allows for just under a 1.2 percent spread between the cost of funds in dollars and the on-lending rate.

4.15 The Program as a whole is exposed to currency risk. An agreement between the Ministry of Finance and MUFIS protects MUFIS against foreign exchange losses beyond the level of its reserve fund provisioning. Additional losses are absorbed by MoF. The decline in the value of the crown has accelerated since MUFIS received its second loan and the exchange rate has become more volatile. In May 1997, the crown fell 8 percent relative to the dollar in a single day, though it subsequently has recovered somewhat. The foreign exchange losses have been partially compensated by a rise in domestic interest rates which has allowed MUFIS to increase earnings on its short-term investments.

4.16 MUFIS may consider raising its on-lending rate to banks. This would both strengthen MUFIS' financial position and bring its lending rate to banks more in line with the domestic cost of funds. MUFIS, USAID, and MoF should discuss the <u>pros</u> and <u>cons</u> of such an adjustment to the Program Agreement.

4.17 MUFIS again elected to receive all of the third tranche financing as a single lump-sum payment which was converted immediately into Czech crowns. This action increased exposure to currency risk. In the future, MUFIS should consider alternative strategies that hold the dollars offshore until they are needed to finance internal on-lending, or that draw down the HG commitment in amounts that more closely correspond to immediately identifiable loan demand.

4.18 Table 19 shows MUFIS' proposed budget for 1997 as of May. It reflects an anticipated further improvement in operations to achieve budgetary balance. However, the budget assumes an average exchange rate of Kč 30.5=US $1.00 in calculating external debt service payments, which is well above the crown's recent trading range.

4.19 **MUFIS' Cost of Capital.** As a result of the decline in the value of the Czech crown, MUFIS' true cost of capital has become very expensive. If the first- and second-tranche HG loan had been repaid on March 15, 1997, two years after the initial borrowing, the annual cost of capital of the HG loan in Czech crowns would have been 16.8 percent. This rate is well in excess of the cost of funds in the domestic market as indicated by bond yields or long-term deposit rates. It illustrates the inherent risks of borrowing in foreign currency.

4.20 MUFIS' experience with international borrowing emphasizes the importance of MUFIS (or CMZRB) developing institutional access to longer-term domestic financing if either institution intends to maintain a permanent presence as a financial intermediary for municipal lending. USAID technical assistance should help MUFIS and CMZRB plan for the transition to mixed domestic and international financing.

Table 19
MUFIS Draft Budget for 1997

Item	Actual 1996 Kč (000) Total	Actual 1996 Breakdown	Projection 1997 Kč (000) Total	Projection 1997 Breakdown
A. Operating Expenses				
1. One Time Fees (time adjusted)				
a) on first tranche	308		309	
b) on second tranche	0		340	
2. Annual Periodic Charges				
a) on first tranche	2,710		3,046	
b) on second tranche	0		743	
3. Charges for Services	1,226		1,570	
a) CMZRB		945		1,157
b) accounting company		176		176
c) auditor		100		100
d) other		5		137
Total Operating Expenses	4,244		6,008	
4. Reserves	1,656		2,024	
a) foreign exchange depreciation fund				1,446
b) cash flow fund				578
B. Operating Revenues:	15		215	
Operating Profit/Loss	**-5,885**		**-7,817**	
C. Finance Operations:				
1. Interest received	48,734		82,255	
a) on provided credits to banks		44,944		54,949
b) on municipal bonds		0		581
c) on securities		0		26,725
d) on current bank account		2,459		0
e) on term deposits (net of tax)		1,332		
2. Interest expense	44,624		73,363	
a) on first tranche		44,624		50,593
b) on second tranche		0		22,770
3. Other Finance Expenses	287		1,032	
4. Other Finance Revenues	10		11	
Profit/Loss from Finance Operation	3,833		7,871	
Profit/Loss of Current Year	**-2,052**		**54**	

4.21 **MUFIS' Institutional Structure and Capacity.** MUFIS' governing bodies are: the Shareholders' General Assembly, the Supervisory Board and the Board of Directors. The powers, responsibilities, and interaction among these bodies are governed by the company's Charter.

4.22 The Shareholders' General Assembly is the supreme governing body of the company. It meets annually. Upon informing the Supervisory Board, the Board of Directors can convene an extraordinary general assembly meeting in addition to the regular one.

4.23 The Supervisory Board oversees the company's activities and approves MUFIS' strategies and policies. It consists of seven members elected by the General Assembly for a three-year term. The Supervisory Board appoints and confirms members of the Board of Directors. According to the Charter, Supervisory Board meetings are convened by its Chairman. Members of the MUFIS' Supervisory Board are registered in the Commercial Court's Register. Mr. Macka, General Director of CMZRB, a 49 percent shareholder, is Chairman. The representative of the Ministry of Finance, also a 49 percent shareholder, Ms. Kameníčková, acts as Deputy Chairman. One of the authors of this report, Petr Tajčman, is also a member of the Supervisory Board.

4.24 In 1996, the Supervisory Board held eight meetings and carried out activities in order to improve and state more clearly MUFIS' policies. Significant effort was spent on securing the third tranche of HG funds in order to maintain continuity of the program.

4.25 The Board of Directors (Executive Board) manages and acts on behalf of MUFIS in executing General Assembly resolutions, and in carrying out Supervisory Board policies and decisions. It consists of five members appointed by the Supervisory Board for three-year terms who meet according to the Charter at least once a month. As MUFIS' executive body, the Board of Directors is responsible for supervising individual contractors and ensuring the quality of services that are provided to MUFIS.

4.26 MUFIS does not have any employees. All functions are carried out through external contractors. General administration, banking, and financial services, including cash management, are provided by CMZRB under a fee arrangement. All financial accounts are maintained at CMZRB.

4.27 The 1996 Monitoring Report called attention to the absence of written agreements between MUFIS, the Ministry of Finance, and CMZRB which produced misunderstandings as to how MUFIS´ losses for 1995 would be covered. To avoid similar uncertainty in 1996, a written agreement between MUFIS and MoF covering MoF´s financial commitments was signed, together with other legal documents regarding the guaranty.

4.28 MUFIS does not have a staff to conduct financial or credit analysis. Unless it obtains external assistance, this will restrict its ability to assume credit risks (e.g., through direct purchase of bond issues) or to expand the range of its financial operations in other ways. To date, MUFIS has accepted assistance from USAID to prepare legal documentation of HG loan offers. However, in the future MUFIS will be expected to contract for any such assistance on its own.

4.29 MUFIS´ long-run goals as an institution, and the capabilities it requires to achieve these goals, need to be identified more clearly. Various visions of MUFIS' longer-term role have been proposed. These range from having MUFIS become a permanent financial intermediary, which obtains capital funds for on-lending from international organizations and the domestic capital market while on-lending to commercial banks to serve specialized niches in the municipal credit market, to phasing out MUFIS in view of the private market's increasing capacity to finance municipalities' borrowing needs. The shareholders of MUFIS need to express a clear sense of MUFIS' future mission.

4.30 **Other Issues.** MUFIS has numerous financial relations with the Czech and Moravian Guarantee and Development Bank (CMZRB), its founder and 49 percent owner. CMZRB handles MUFIS' administrative responsibilities and carries out cash management under a management contract with MUFIS. Most of MUFIS' cash on hand has been invested in CMZRB financial instruments, sometimes at below-market rates of interest. CMZRB has sold to MUFIS a portion of the only municipal bond it has underwritten. These financial connections make it important that arm's-length relations are maintained between MUFIS and CMZRB. MUFIS was created as a financial intermediary for the entire Czech banking sector in order to support competition within the sector.

4.31 It is recommended that all financial transactions between CMZRB and MUFIS, as well as transactions between MUFIS and other institutions with which Board members are affiliated, be committed to writing and require the signature of two outside members of the appropriate MUFIS board.

V. THE CZECH MUNICIPAL CREDIT MARKET AND MUNICIPAL INFRASTRUCTURE FINANCING

5.01 The Municipal Infrastructure Finance Program seeks to help establish a workable municipal credit market in the Czech Republic. The ultimate test of its success is the way that market performs.

5.02 Prior to 1992, municipal borrowing to finance local infrastructure projects was virtually non-existent in the Czech Republic. The system inherited from the previous regime made municipalities almost totally dependent on central authorities for capital financing. Over 70 percent of local revenues came from the state budget, and almost all local capital investments were financed by state subsidies or state grants.

5.03 With progress in decentralization and the deepening of democratization in the Czech Republic, a new tax and local government financing system was adopted beginning January 1, 1993. This reform eliminated many of the traditional central subsidies for local government, and replaced them with shared tax revenues, treated as "own source" revenues in the Czech (and EU) public accounting system. Shared taxes are centrally collected and then apportioned to local budgets. The largest proportion of centrally collected revenues is distributed on the basis of local expenditure needs, rather than by point of revenue generation. Table 20 shows the shared taxes and the ratio allocated to municipal governments for each tax.

Table 20
Municipal Portion of Shared Taxes

	1993	1994	1995	1996	1997
	%	%	%	%	%
Personal Income Tax	40	50	55	30	30
Unincorporated Income Tax	100	100	100	100	100
Corporate Income Tax	0	0	0	20	20
Property Tax	100	100	100	100	100

5.04 Further changes in intergovernmental financing were made in 1996. These changes aimed at two main objectives. First, they attempted to balance the rate of growth of local budgets and the national budget. Second, they sought to reduce differences in tax revenues per capita among the municipalities. Yields from the personal income tax are the most rapidly growing source of revenue in the Czech Republic. Until 1996, personal income taxes were allocated completely to the sub-national level--either to municipalities or districts. One consequence of this arrangement was that municipal revenues from nationally collected taxes were growing significantly faster than revenues retained by the state. The 1996 reforms allocate personal income tax receipts among the State, district offices and municipalities in the ratio 40:30:30. The Corporate Income Tax became a new revenue source for municipal budgets; 20 percent of receipts are allocated to municipalities. Because revenues from the Corporate Income Tax show little secular growth (due to repeated reductions in the corporate tax rate), the overall growth in municipal revenues has been reduced to roughly equal the rate of revenue growth in the state budget. Differences in per capita tax revenues among municipalities are being reduced because yields from the Corporate Income Tax are distributed among municipalities on a uniform per capita basis.

5.05 Shared Tax Revenues represent nearly 50 percent of total municipal budgetary revenues. The relative importance of individual taxes is shown in the Graph.

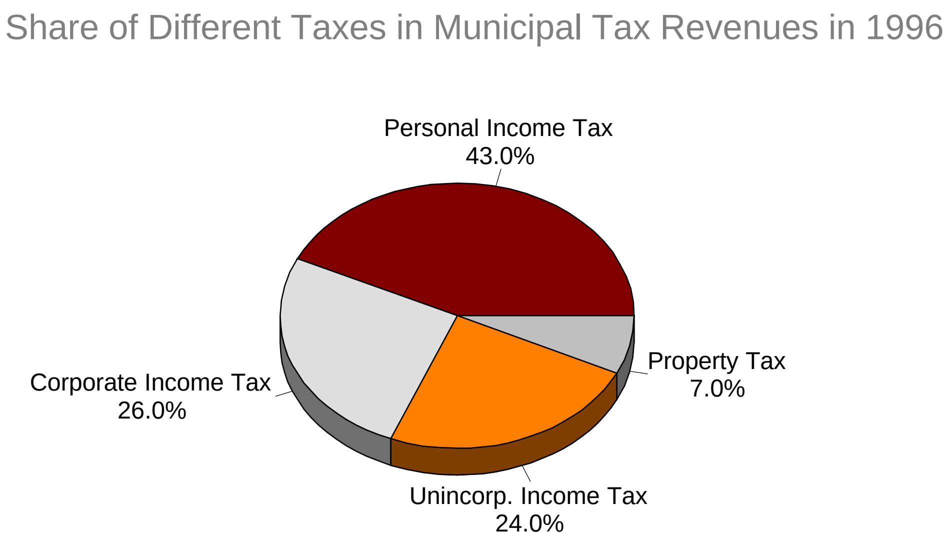

Figure 2

5.06 Another source of municipal own revenues is represented by local fees. Municipalities are authorized by law to impose the following six local fees: dog fees, fees on spa or recreational stays, facility bed charges, fees on using public space, fees on entrance charges, and fees on car permits to enter certain parts of municipalities. Local fees are collected by the municipality. They account in total for only 1.5 percent of municipal revenues. They are more important for the budgets of small municipalities.

5.07 **Recent Fiscal Developments.** The fiscal situation of the Czech Republic deteriorated at the end of 1996. Real GDP growth at 4.1 percent for 1996 fell short of the 5.5 percent target. As a result, budget revenues did not reach projected levels, either in the central budget or in local budgets. Actual tax revenues allocated to local budgets in 1996 were lower by 0.4 percent than projected. Transfers from the central budget to municipalities were 3.7 percent lower than projected.

5.08 This unfavorable trend has continued into 1997. The national trade deficit has continued to grow. GDP growth for 1997 is now projected at no more than 1.5 percent. In response to the economic and fiscal difficulties, the Czech government first adopted a so-called “mini measures package” in the second half of April, which includes cuts in local government revenue allocations. Further restrictive fiscal measures are expected throughout 1997.

5.09 **Aggregate Municipal Credit**. There currently are very few restrictions on municipal borrowing in the Czech Republic. The law enables municipalities to enter both the domestic and foreign loan markets without any restrictions concerning either the purpose for which the municipality wants to borrow, or the structure of a loan, including the date of maturity and the interest rate. To issue bonds, a municipality has the obligation, like all other subjects, to apply for an issue permit at the Ministry of Finance and the Czech National Bank. The national government review is primarily for the legal form of bond issues, but also includes a judgment as to whether bond issuance is financially prudent.

5.10 In addition to legal flexibility, the stability and predictability of municipalities’ shared tax revenues have given them considerable financial latitude in taking on debt. One component of the “mini measures package,” however, calls for the Ministry of Finance “to impose regulations on municipal debt.” Regulation of municipal debt is aimed at protecting Czech municipalities from overindebtedness and also at limiting sub-national borrowing for macroeconomic reasons. The Ministry of Finance reports that fewer than 10 small municipalities (up to one thousand population) presently are facing problems with their debt service.

5.11 Table 21 shows that despite the rapid growth of municipal borrowing (commercial plus non-commercial), debt outstanding for the municipal sector has not reached warning levels. Aggregate debt service ratios are under 4 percent. Regulation is intended to keep municipal debt within prudent levels, especially at a time when the pressure to borrow may increase because of reductions in central government tax sharing and transfers.

5.12 The legal and financial system established by the Czechs has created generally favorable conditions for development of the municipal credit market. However, a number of impediments inherited from the previous system had to be dealt with. A single institution previously handled the

Table 21
Municipal Indebtedness

	1993	1994	1995	1996
Outstanding Debt (bill. of Kč)	2.9	14.1	22.7	32.2
Debt Service (bill.)	-*	1.7	3.4	5.6
Total Expenditure (bill.)**	90.2	112.1	131.1	144.4
Total Revenue (bill.) ***	101.3	119.5	148.9	186.1
Outstanding Debt/ Total Expenditure (%)	3.2%	12.6%	17.3%	22.3%
Outstanding Debt/ Total Revenue (%)	2.9%	11.8%	15.2%	17.3%
Debt Service/Total Expenditure (%)	-	1.5%	2.6%	3.9%
Debt Service/Total Revenue (%)	-	1.4%	2.3%	3.0%

* Data were not reported in 1993

** Both expenditure and revenue totals exclude targeted subsidies from the state for functions that municipalities perform on behalf of the state.

*** Includes revenue from borrowing, asset sales, and carryover of surplus from previous year, per Czech accounting conventions

Source for Outstanding Debt: Table 28

Source for Debt Service, Total Expenditure and Total Revenue: Survey of Municipal Budget Balance

overwhelming majority of municipal loans and individual savings deposits. There was very little recent experience with long-term or even intermediate-term lending for municipal investment. Most municipal loans were short-term bridge loans to cover cash shortfalls. There were no municipal bonds and no activity in the municipal sector by foreign banks. The primary policy goals of the Municipal Infrastructure Finance Program have been to help inject competition into the municipal credit market, and to improve the conditions of municipal borrowing for infrastructure investment, by lengthening the terms of loans, lowering interest rates, and improving collateral conditions.

5.13 Access to long-term capital is crucial to successful financing of infrastructure projects. The Czech National Bank defines “long term” loans as loans of four-year maturity or greater, “medium term” as loans of one to three years, and “short term” as loans shorter than one year. As shown in Table 22, total commercial loans outstanding to municipalities increased by a factor of nearly five times between 1993 and 1996. Long-term loans outstanding climbed at a still faster rate--by almost 12 times.

Table 22
Volume and Term Structure of Municipal Commercial Credit Outstanding

Type of Credit	December 31, 1993		December 31, 1994		December 31, 1995		December 31, 1996	
	Kč(000)	%	Kč(000)	%	Kč(000)	%	Kč(000)	%
Short term[a]	632,960	31.8	769,244	18.2	1,802,455	24.6	525,541	5.8
Medium term[b]	818,761	41.3	1,663,129	39.4	1,916,579	26.1	2,331,599	25.4
Long term[c]	532,661	26.9	1,790,081	42.4	3,611,176	49.3	6,309,794	68.8
Total	**1,983,382**	**100.0**	**4,222,454**	**100.0**	**7,330,210**	**100.0**	**9,166,934**	**100.0**

a. Less than one year.
b. 1 - 3 years.
c. 4+ years.

5.14 The aggregate shift in the structure of municipal commercial debt from short and intermediate term to long term has been impressive. The share of long-term loans in total municipal debt increased from 27 percent at the end of 1993 to almost 70 percent at the end of 1996. The share of both short-term and intermediate-term debt fell during this period. The lengthening of loan maturity provides a more stable basis for infrastructure financing and alleviates the threat of a financial crisis resulting from municipalities' inability to roll over short-term debt. Unfortunately, no data are available regarding the total volume of loans of seven or ten years' maturity or longer, which would be considered long-term in the United States or Western Europe.

5.15 MUFIS' role in overall credit market development can be judged in relation to the aggregate data shown in Table 22. MUFIS accounted for a moderate share--about 15 percent--of the net increase in municipal lending during 1995. However, it accounted for a larger share of its intended market. Bank loans through MUFIS accounted for 25 percent of net "long-term" lending (4 years maturity or longer) in 1995, and a much higher, but unknown, proportion of lending of 7 years or longer. MUFIS-sponsored loans also helped increase competition in municipal lending. They financed two-thirds to three-fourths of all long-term municipal lending by other than the dominant bank in the municipal sector, Česká spořitelna. However, in 1996 the municipal credit market continued its structural development with only modest contributions from MUFIS.

5.16 The aggregate shift from short term to long term credits has been accompanied by a lowering of interest rates in the municipal sector. At the beginning of 1993, long-term municipal loans and municipal bonds carried interest rates in the range of 14 percent to 16 percent. During 1996, these interest rates stood in the range of 11.2 percent to 12.5 percent. (There is no index of municipal interest rates in the Czech Republic.) The decline in interest rates for municipal loans has been steeper than the decline in other lending rates. This reflects improvement in the perceived creditworthiness of municipalities as a result of their high rates of timely loan repayment, as well as the credit market's greater familiarity with municipal budgeting and municipal credit risk. Interest rates for all clients can be expected to rise in 1997, as a result of the deteriorating financial situation.

5.17 The Ministry of Finance reports that about one thousand municipalities have borrowed from commercial banks, or about 16 percent of all municipalities in the Czech Republic. The Czech Savings Bank alone reports that it has provided more than 1,250 different municipal loans since 1994, with a "problem loan" rate of less than 1 percent.

5.18 Table 23 demonstrates that total commercial lending to municipalities has been growing far more rapidly than the rest of the commercial credit market, especially for long-term credits. Long-term municipal credit (four-year loans or longer) doubled between 1994 and 1995 in the municipal sector, and increased by another 75 percent in 1996.

5.19 Still, the municipal share of all commercial bank credit was only 1.0 percent at the end of December 1996. [Table 24.] Municipal credit was a somewhat more significant factor in long-term lending. Municipalities' long-term debt accounted for 2.3 percent of all long-term debt owed to domestic commercial banks. As a point of comparison, outstanding municipal credits (both loans and bonds) represented 8.5 percent of outstanding domestic credits (loans and bonds) during the period 1993-95 in the United States.[8]

Table 23
Growth of Commercial Bank Credits, between December 31, 1994, December 31, 1995 and December 31,1996 in Kč (billion)

	1994	1995	1996	%Growth	
				95/94	96/95
Total	**784.0**	**836.7**	**895.5**	**6.7%**	**7.0%**
Non-Financial Organizations	593.9	643.5	726.3	8.4%	12.9%
Local Government	4.2	7.3	9.2	73.8%	26.0%
Total Long-Term (4+ years)	**237.0**	**250.3**	**275.6**	**5.6%**	**10.1%**
Non-Financial Organ., Long-Term	157.3	170.8	212.8	6.9%	24.6%
Local Government, Long-Term	1.8	3.6	6.3	100%	75%

The overall structure of the Czech credit market is quite different from that in the United States. Central government debt is a tiny proportion of the total (1.1 percent), because of the Government's balanced budget record. Home mortgage borrowing has just begun.

Table 24
Structure of Commercial Bank Credits Outstanding According to Type of Borrower as of December 31, 1996 (Kč billion)

	Short Term[a]		**Medium Term[b]**		**Long Term[c]**		**Total**	
	Kč (bill.)	**%**	**Kč (bill.)**	**%**	**Kč (bill.)**	**%**	**Kč (bill.)**	**%**
Total	387.9	100.0	232.0	100.0	275.6	100.0	895.5	100.0
Non-financial organizations	338.0	87.1	175.5	75.6	212.8	77.2	726.3	81.1
Monetary & in-surance organiz.	22.8	5.9	10.0	4.3	1.0	0.4	33.8	3.8
Governmental sector total from it:	1.1	0.3	2.5	1.1	13.8	5.0	17.4	1.9
Central government	0.6	0.2	0.1	0.1	7.5	2.7	8.2	0.9
Local government	0.5	0.1	2.4	1.0	6.3	2.3	9.2	1.0
Non-profit organizations	0.9	0.2	0.3	0.1	0.2	0.1	1.4	0.2
Self employees	18.2	4.7	31.8	13.8	15.6	5.6	65.6	7.3
Population	2.2	0.6	6.8	2.9	28.9	10.5	37.9	4.2
Other	4.7	1.2	5.1	2.2	3.3	1.2	13.1	1.5

a. Less than one year.
b. 1 - 3 years.
c. 4+ years.

5.20 Municipal bonds have also come to play an important role in the Czech municipal credit market. By the end of 1996, 18 municipalities had issued bonds reaching a total of Kč 11,926 million, or 30 percent more than the total volume of bank credits. A substantial share of the total volume of bonds is represented by the capital city of Prague, which issued bonds denominated in U.S. dollars valued at Kč 7.3 billion. This represents 61 percent of the total volume of municipal bonds. The

Ostrava bond issue also was sold in the foreign market, denominated in German marks. The maturity of the municipal bonds ranges from 5 to 10 years; recently interest rates have clustered between 11.5 and 13 percent. The size of domestic issues has ranged from Kč 8.5 million to Kč 1.2 billion. Municipal bond activity is shown in Table 25. Annex B describes key characteristics of each of the individual bond issues.

Table 25
Municipal Bonds in Kč (million) Issued in the Years 1992-1996

	1992	1993	1994	1995	1996	1992-1996
Number	1	1	8	3	5	18
Total Amount	8.5	20.0	7,869.3	660.0	3,368.2	11,926.0
Total Amount Excluding Prague	8.5	20.0	575.0	660.0	3,368.2[a)]	4,631.7

a) Including the second tranche of Pilsen Bonds (200 million Kč) which was approved in 1995.

5.21 In 1996, the number of municipal bond issues increased slightly, whereas their volume increased significantly. This is a result of an increasing average size of individual issues. In 1996 the second and the third biggest cities issued bonds. A segmentation of the credit market is developing, in which large volumes of borrowing are handled through the bond market, while smaller credits are handled as traditional bank loans.

5.22 There is no official overview of municipalities' foreign loans. According to the Ministry of Finance 20 cities bear foreign debt (excluding the Prague bond issue and Ostrava bond issue) having a total value of Kč 600 million.

5.23 **Subsidized State Lending.** An important part of municipal borrowing consists of interest-free loans granted by the State Environmental Fund, Ministry of Agriculture, and Ministry of Finance. These loans have the character of "reimbursable financial assistance." The State Environmental Fund started to grant such loans in 1992, the Ministry of Finance and the Ministry of Agriculture in 1994. These loans can only be granted for specific types of investments. The State Environmental Fund provides loans to municipalities for conversion of heating systems, solution of household solid waste-handling problems, wastewater treatment plants, and sewage systems. The Ministry of Agriculture grants loans for construction of water-distribution systems, drinking-water treatment plants, construction of sewage systems and wastewater treatment plants. The Ministry of Finance provides reimbursable financial assistance for construction of major water-development projects, for reconstruction or construction of public facilities (schools and hospitals), for modernization and construction of housing, and for rural revitalization. The volume of zero-interest lending by the State is summarized in Tables 26 and 27.

Table 26
Zero Interest State Loans to Municipalities in Kč (billion)

	1993	1994	1995	1996	1993-1996
Ministry of Finance	0.0	0.5	0.9	0.3	1.7
Ministry of Agriculture *	0.0	0.2	0.6	0.6	1.4
State Environmental Fund **	0.6	0.9	1.1	1.5	4.1
Total	**0.6**	**1.6**	**2.6**	**2.4**	**7.2**

* This amount includes only reimbursable financial assistance granted directly to municipalities and cities. The Ministry of Agriculture also provides reimbursable financial assistance to voluntary unions of municipalities and to joint-stock water companies, where the municipalities are the majority owners. Including these loans, the total amount of interest-free loans then reaches 0.4 billion crowns in 1994 and 1.0 billion crowns in 1995 and 1.3 billion crowns in 1996.
** Net lending. See Table 27 for gross amounts.

5.24 The payment schedules of these interest-free loans vary. The most common loan conditions call for annual principal repayments for 10 years, commencing at the time of project completion, or in the case of the Environmental Fund, a five-year grace period on payments followed by five years of equal principal repayments. A third way of paying off reimbursable financial assistance is a one-time payment after 10 years. Only a handful of zero-interest loans have had principal payments due to date. These are primarily loans from the Environmental Fund, which initially had a three-year grace period (see Table 27). Some municipalities appear not to have budgeted adequately for future debt service on state loans. In fact, the whole system of subsidized state lending deserves careful monitoring, since there is a danger of substantial default rates which may spill over into commercial loans.

Table 27
Zero Interest Loans Provided to Municipalities by State Environmental Fund in Kč (billion)

	1992	1993	1994	1995	1996	1992-1996
Loans	0.1	0.5	1.0	1.3	1.6	4.5
Payments	-	-	0.1	0.2	0.1	0.4
Outstanding Loans	0.1	0.5	0.9	1.1	1.5	4.1

5.25 The aggregate volume of municipal debt reported in the Czech Republic varies somewhat by data source. Table 28 is based on information published by the director of the Municipal Budget Department of the Ministry of Finance in May 1997. Table 29 is based on information published by the Czech National Bank plus information provided by the Ministry of Agriculture and SEF. The rest of the report utilizes the data presented in Table 28.

5.26 The difference between sources is greatest as regards the amount of commercial credit outstanding. The Czech National Bank reports lower outstanding debt than the Ministry of Finance. The Czech National Bank gathers data on loans provided by commercial banks operating in the Czech Republic, while the Ministry of Finance relies on municipal financial statements. In these statements all commercial loans are reported, including loans from equipment suppliers and loans from overseas institutions.

Table 28
The Structure of Municipal Outstanding Debt in Kč (billion)
(Ministry of Finance)

	1993		1994		1995		1996	
	Kč(mill.)	%	Kč(mill.)	%	Kč(mill.)	%	Kč(mill.)	%
Commercial credits	2.5	86.0	4.9	34.5	8.7	38.3	11.6	36.0
Bonds	0.03	1.0	7.7	54.2	8.5	37.5	11.9	37.0
Debt of small municipalities [1)]	0.3	10.0	0.5	3.6	0.9	4.0	1.4	4.3
Reimbursable financial assistance					1.8	7.9	2.9	9.0
Loans from SEF	0.1	3.0	1.1	7.7	2.8	12.3	4.4	13.7
Total	**2.9**	**100**	**14.2**	**100**	**22.7**	**100.0**	**32.2**	**100.0**

[1)]This debt is reported separately, because small municipalities use the simplified form and it is not possible to distinguish commercial debt from non-commercial debt
Source: Vera Kameníčková, (Director of Municipal Budgets Department, Ministry of Finance CR), Deficit and Debt, in Moderní obec, number 5, page 16

5.27 As can be seen from either Table 28 or Table 29, total municipal debt grew rapidly over the period 1993-1996. The total volume of debt outstanding increased by roughly ten times during these four years. All segments of the municipal credit market have shown dramatic growth, though the magnitude of the Prague bond issue tends to distort more detailed comparisons. The amount of zero-interest lending is noteworthy. It represents implementation of a state policy to subsidize environmental and other specific investments through subsidized lending rather than through outright capital grants or state construction.

Table 29
The Structure of Municipal Outstanding Debt in Kč (billion)
(Czech National Bank)

	1993		1994		1995		1996	
	Kč(bill.)	%	Kč(bill.)	%	Kč(bill.)	%	Kč(bill.)	%
Commercial credits*)	2.0	76.0	4.2	29.4	7.3	35.3	9.2	32.5
Bonds	0.03	1.1	7.9	55.2	8.6	41.5	11.9	42.0
Zero-interest loans	0.6	22.9	2.2	15.4	4.8	23.2	7.2	25.4
Total	**2.6**	**100.0**	**14.3**	**100.0**	**20.7**	**100.0**	**28.3**	**100.0**

Source: Czech National Bank, SEF, Ministry of Agriculture, and Ministry of Finance

5.28 The share of all kinds of central government subsidies--operating subsidies and capital subsidies--in local budgets has declined substantially and continuously since 1993. Commercial borrowing, while relatively modest as an overall financing source, has grown rapidly. This global budget picture is summarized in Table 30.

5.29 **Overall Financing of Municipal Infrastructure Investment**. Municipal capital expenditures grew steadily from 1993 to 1995, both in real terms and as a percentage of local budgets (see Table 31). The Czech Republic was the only country in Central and Eastern Europe where the investment share of local budgets increased in this manner. It also has the highest investment share of local budgets. In 1996, however, the investment share of municipal budgets declined for the first time. Real municipal investment also fell, as the 4.9 percent increase in investment was outpaced by the 8.8 percent rate of inflation.

5.30 We can expect further reductions in real levels of municipal infrastructure investment in 1997. Government has reduced tax sharing allocations and transfers to municipalities, which is likely to force local governments to use a greater share of their total budgets for current financing. The same factors are likely to increase reliance on credit for capital financing.

Table 30
Share of State Subsidies and Borrowings in Aggregate Municipal Budgets (Excludes Prague Bond)

	1993		1994[e]		1995		1996	
	Kč (bill.)	%	Kč (bill.)	%	Kč (bill.)	%	Kč (bill.)	%
Total Subsidies[a]	27.9	27.5	30.2	25.3	34.9	23.4	33.6	18.1
Zero-Interest Loans[b]	0.4	0.4	1.2	1.0	2.9	2.0	2.7	1.5
Commercial Borrowing[c]	2.1	2.1	4.2	3.5	6.7	4.5	9.7	5.2
Own-Source Revenue	70.9	70.0	83.9	70.2	104.4	70.1	140.1	75.3
Total Revenue[d]	**101.3**	**100.0**	**119.5**	**100.0**	**148.9**	**100.0**	**186.1**	**100.0**

a. Includes grants and other subsidies. Source: Survey of Municipal Budget
b. Source: Table 29
c. Includes both municipal loans and municipal bonds, Source: Survey of Municipal Budget
d. Borrowing and transfers of previous year surplus are included as "revenue."
e. Excludes Prague bond issue. With Prague bond issue included, the totals for 1994 are:

	Kč (bill.)	percent
Subsidies	30.2	23.8
Zero-Interest Loan	1.2	0.9
Borrowing	11.5	9.1
Own-Source Revenue	83.9	66.2
Total Revenue	126.8	100.0

Table 31
Capital Investment Share of Aggregate Municipal Budgets

	Kč (bill.)			
	1993	1994	1995	1996
Expenditure	90.2	112.1	131.1[a]	144.4[b]
From it: Investment expenditure	31.6	42.4	50.9	53.4
Investment share in total expenditure	35.1%	37.8%	38.8%	37.0%

a. Total expenditure was 132.3 billion. Social benefits which started to be paid through municipal budgets from November 1995 are subtracted to make the data comparable with previous years
b Total expenditure was Kč 171.1 billion . Social benefits reached Kč 26.7 billion.

5.31 It is difficult to fully separate out the sources of financing for municipal investment because separate capital budgets are not used in the Czech Republic. Nonetheless, it is important to understand the local capital financing mix insofar as possible. The estimates reported below are based on certain assumptions:

- All commercial loans and interest-free credits, regardless of their time structure, are assumed to be used for financing investment construction in the year they are received.

- Municipal bond proceeds are assumed to finance investment in different years. Each municipality issuing bonds was contacted to determine the time profile over which it invested the bond proceeds.

- Capital subsidies consist of specific grants for capital construction as well as the capital component of functional transfers and regional equalization transfers. The methods used to estimate the capital portion of state transfers have been described in previous papers. All capital subsidies are assumed to be used in the year of receipt.

5.32 Table 32 provides an overview of the sources of municipal capital investment financing based on these assumptions. It shows that the share of municipal investment financed by both commercial lending and state-subsidized, zero-interest lending has been rising steadily. Over the entire period, the importance of state capital subsidies has fallen dramatically from just under half of local capital budgets in 1993 to just over one quarter of local capital budgets in 1996. Most of the decline in capital subsidies occurred in 1996, and is continuing into 1997. Local governments' own resources (i.e., their operating budget surpluses) now finance more than half of all local capital spending. The share of capital investment financed by operating surpluses, as opposed to debt, confirms the basically conservative attitude most local officials have toward borrowing.

Table 32
Municipal Infrastructure Financing (including Prague)

	1993		1994		1995		1996	
	Kč (bill)	%	Kč (bill)	%	Kč (bill)	%	Kč (bill)	%
Investment Expenditure	31.6	100.0	42.4	100.0	50.9	100.0	53.4	100.0
Financing Sources: Capital Subsidies	15.7	49.7	14.3	33.7	19.1	37.5	13.6	25.5
Commercial Debt	2.1	6.7	5.5	13.0	9.2	18.1	9.1	17.0
Zero-Interest Debt	0.4	2.5	1.2	5.0	2.9	5.7	2.7	5.1
Own Resources	13.4	41.1	21.4	48.3	19.7	38.7	28.0	52.4

VI. POLICY OBJECTIVES AND POLICY IMPACTS

6.01 An important innovation of the Program Agreement is Annex B of the Program Agreement, the Policy Action Plan. This Annex spells out the "mutual institutional and sectoral goals" that the parties propose to pursue through the program. It identifies specific policy objectives for the sector, and specific indicators to measure progress toward meeting those objectives. The Policy Action Plan has been given a central role in program implementation, because the purpose of the Program is to institutionalize a well-functioning credit market that complements the rest of the Czech system for financing local governments.

6.02 This section identifies each of the original policy Objectives and the Indicators that it was agreed would be used for measurement purposes. It assesses progress toward meeting each element of the Policy Action Plan.

6.03 The Program Agreement specifically recognizes that the policy objectives of the Program should be met through several lines of activity. The municipal loans by MUFIS through HG funds are intended to directly embody the policy objectives. The technical assistance provided by USAID is intended to help equip Czech institutions to achieve these objectives on their own, as well as through MUFIS. Finally, Czech institutions of all kinds are rapidly maturing through their own learning as well as through technical assistance from other parties and market dealings with financial institutions in the West.

6.04 **Objective 1: A Functioning Borrower (MUFIS) that is financially sound and that stimulates and encourages non-governmental lending to local governments for sustainable infrastructure projects.**

6.05 The agreed- upon indicator for this objective is an institution that is "properly staffed, housed, equipped, having established regulations, policies, and procedures and having made one or more loans to Participating Institutions for infrastructure projects."

6.06 MUFIS is fully functioning. It has made 27 loans and disbursed 100 percent of the funds received in the first two tranches of the HG financing. It has begun disbursement of the second tranche received in March 1997. MUFIS has not implemented the staffing recommendations made in USAID's original technical assistance plan, but has relied on CMZRB personnel to provide financial and management services. This is a prudent and cost-effective decision. As noted in the body of this report, MUFIS greatly narrowed its operating losses in 1996. It substantially improved its cash management, as a result of Supervisory Board instructions to increase earnings on short-term investments, net of tax withholding. All in all, MUFIS made great strides in 1996 as an operating entity.

6.07 The Program's financial risk now derives primarily from the vulnerability of the Czech crown. Although MUFIS as an institution is protected from foreign exchange losses by its agreement with MoF, it is in MUFIS' interest to broaden its activity and begin to raise capital in the domestic market if it intends to maintain a permanent presence as a financial intermediary supporting the municipal credit market.

6.08 MUFIS is also exposed to risks deriving from uncertainty about the future of the Housing Guaranty loan program in the United States. The interruption in HG lending cost MUFIS credibility in the market place in 1996. The inability to forecast HG lending in the future hampers MUFIS' longer-run planning.

6.09 **Objective 2: Demonstration that properly designed municipal lending involves acceptable credit and business risks and that it therefore is financially sound for banks and other private financial sector institutions to increase municipal lending from their own resources, subject to normal market considerations.**

6.10 One agreed-upon indicator for this objective is a good record of MUFIS loan repayment. Annex B of the Program Agreement specifies a target problem loan rate of no more than 5 percent. All of the loan payments due to MUFIS by banks and to participating banks by municipalities have been made in full and on time. There are no problem loans. The standard of performance therefore has been met in full and exceeded. MUFIS´ loans to date generally appear to reflect prudent levels of indebtedness, both for the individual loans and for the overall debt structure of the borrowing municipalities. However, a few of the borrowing municipalities now have very high total debt service burdens and should be monitored closely.

6.11 More importantly, there have been no defaults reported on <u>any</u> commercial municipal credits in the Czech Republic, despite the very rapid growth in municipal lending. Česká spořitelna, the largest lender to municipalities, reports that less than 1 percent of payments are 30 days or more past due. The Czech National Bank has classified municipal debt as the second safest category of debt in the country, trailing only the debt obligations of the State. Indeed, this exemplary record with respect to repayment is largely responsible for the increasing volume of market-based loan activity. This Program policy objective has also been met in full and exceeded.

6.12 Nonetheless, there are signs of increased risk in municipal lending. In particular, the repayment rate on State subsidized loans is unclear. The State Environmental Fund estimates that a substantial portion of its loans may not be repaid in full and on time. Such a poor repayment record could infect the commercial credit market, if municipalities come to believe it is not obligatory to meet debt service. The government's proposed initiative to regulate future municipal borrowing is well-timed, given the possibility that some municipalities may try to replace declining state subsidies and tax sharing with new borrowing.

6.13 **Objective 3: A substantial increase in the annual levels of commercial lending to the local government infrastructure sector from all non-governmental sources, both in absolute terms and relative to central government investment subsidies for local government investment.** The intent behind this objective was to encourage substitution of market-rate capital borrowing for central government subsidies in financing part of local investment.

6.14 The agreed-upon indicators for this objective were that:

(a) Annual non-governmental lending [to municipalities] should exceed US $20 million equivalent by the end of 1995.

(b) Commercial-rate credit should grow faster than central government subsidies as a source of financing for local government capital spending, using 1993 as a baseline.

6.15 As detailed in Tables 21, 22, 28, and 30 of the report, the volume of non-governmental lending has vastly exceeded the Program target. Moreover, the share of commercial credit in local capital financing has grown, while the share of state capital subsidies has fallen precipitously. The Program objectives of moving toward more market-oriented capital financing therefore have been met in full and exceeded.

6.16 **Objective 4: Demonstration of increased municipal capital investment in basic infrastructure.**

6.17 The agreed-upon indicator for Objective 4 is a 10 percent per annum increase in the real level of local government capital investment starting in 1993. As demonstrated in Section V, this goal was met in full and surpassed between 1993 and 1995. Czech municipalities started the period with the highest share of local budgets devoted to capital investment of any of the countries of Central and Eastern Europe, and were able to increase their investment share through 1995. Real investment levels declined in 1996, however, and are likely to decline again in 1997, due to fiscal pressure.

6.18 **Objective 5** of the Policy Action Plan differs in character from the other objectives and indicators, in that it involves qualitative assessments of municipalities' and banks' financial practices: **Demonstration of improvement in the budgeting and financial management capabilities of local governments and in the quality of infrastructure project preparation, especially as regards market-demand and cost recovery studies. Improvement in the financial appraisal of municipal loan applications by banks and other financial institutions.**

6.19 The agreed upon indicator for Objective 5 is a qualitative assessment of change in municipal budgeting procedures and change in bank loan appraisal procedures.

6.20 No general assessment was conducted of baseline budgeting practices in Czech municipalities at the start of the Program. Without systematic comparative information, it is impossible to generalize about the improvements in financial management and budgeting that may have occurred in the universe of Czech municipalities. The Union of Towns and Communities, in collaboration with USAID, however, has prepared user-friendly municipal budgeting software that is in widespread use throughout the country. The first national conference of municipal finance officers was convened in September 1996. The qualitative assessment of USAID's technical advisors is that the quality of municipal budget and capital project preparation has improved immensely since 1993. As part of the first municipal finance officers' conference, a questionnaire was distributed on budgeting practices, with special attention to capital budgeting and investment financing. Administration of a parallel questionnaire in September 1997 at the second annual Conference will provide concrete information on the changes in municipal budgeting practice.

6.21 All of the <u>banks</u> making loans under the MUFIS program or participating in USAID's bank training program (which include the four largest banks in the Czech Republic) have introduced new methods of credit assessment for municipal lending. Banks have received two rounds of joint seminars on assessing municipal creditworthiness and loan evaluation. All of the banks actively participating in the Program subsequently received intensive individualized training. Seminar instructors from the U.S. have reported a vast increase in banks' capacity to perform realistic, swift credit analysis without burdening municipalities with requests for irrelevant information.

ANNEX A

SUMMARY DATA ON INDIVIDUAL MUNICIPAL LOANS

UNDER MUFIS PROGRAM

REALIZED PROJECT			Amount Kč (000)	Amount US$ (000)	Maturity Years	Interest Rate (%)	Name of the Bank	Number of Households	Number of Households (%)
	Municipality	Project							
1.	Vratimov I	co-generation for residential heating	40,000.0	1,542.7	14	11.5	COOP, a.s.	227	11
2.	Buèovice	gas installation, water distribution, infrastructure	20,000.0	771.4	14	11.5	COOP, a.s.	351	15
3.	Bruntál	metering and control devices (heating)	10,153.0	391.6	10	11.5	COOP, a.s.	3,000	55
4.	Opava	metering and control devices (heating)	22,500.0	867.8	15	11.0	COOP, a.s.	2,725	14
5.	Jablùnka	gas installation	10,000.0	385.7	10	11.5	COOP, a.s.	680	100*
6.	Bystøièka	gas installation	10,000.0	385.7	10	11.5	COOP, a.s.	300	89
7.	Tøebíè	infrastructure reconstruction, dam, footbridge	40,000.0	1,542.7	14	11.5	COOP, a.s.	350	4
8.	Vítkov	solid waste landfill	12,000.0	462.8	10	12.0	KB, a.s.	3,600	100*
9.	Kralupy n. Vltavou	gas installation, building insulation	26,630.0	1,027.1	14	12.0	KB, a.s.	712	13
10.	Svatava	gas installation	12,000.0	462.8	15	12.0	KB, a.s.	260	56
11.	Frýdlant	co-generation for residential heating	45,360.0	1,749.5	14	12.0	KB, a.s.	1,200	50
12.	Dolní Domaslavice	gas installation	10,000.0	385.7	15	12.0	KB, a.s.	211	66
13.	Pardubice	sewer collection, infrastructure reconstruction	22,000.0	848.5	10	11.0	KB, a.s.	4,750	16
14.	Slavièín	gas installation, solid waste landfill	14,000.0			11.0	KB, a.s.		

REALIZED PROJECT			Amount Kč (000)	Amount US$ (000)	Maturity Years	Interest Rate (%)	Name of the Bank	Number of Households	Number of Households (%)
Municipality		Project							
15.	Topolná	sewer collection and treatment	10,000.0	327.0	10	12.0	KB, a.s.	485	92
16.	Nýdek	water distribution, sewer collection, gas installation	13,000.0	501.4	10	12.0	PGB, a.s.	418	65
17.	Dolní Kounice	water distribution, gas installation	15,000.0	577.4	15	12.0	PGB, a.s.	500	67
18.	Ledeè n. Sázavou	sewer collection and treatment	25,000.0	964.2	10	11.75	PGB, a.s.	1,650	75
19.	Velké Losiny	sewer collection, gas installation	25,000.0	964.2	15	12.0	PGB, a.s.	650	68
20.	Vratimov II	co-generation for residential heating	40,000.0	1,542.7	14	11.5	PGB, a.s.	227	11
21.	Bystøice p. Hostýnem	sewer collection and treatment, metering and control devices (heating)	18,000.0	694.2	10	11.5	PGB, a.s.	3,250	100*
22.	Jesenice	water distribution	17,000.0	655.7	14	12.0	IPB, a.s.		
23.	Slavkov u Opavy	sewer collection and treatment	10,000.0	385.7	10	12.0	IPB, a.s.	450	82
24.	Blansko	sewer collection, infrastructure reconstruction	7,000.0	270.0	7	11.5	IPB, a.s.		
25.	Slavkov u Brna	infrastructure reconstruction, square reconstruction	19,000.0	732.8	15	12.0	IPB, a.s.	1,200	60
26.	Prùhonice	sewer collection and treatment	15,000.0	577.4	15	12.0	IPB, a.s.		
27.	Mikulovice	water distribution, gas installation	10,500.0	405.0	10	12.0	IPB, a.s.	900	100

* Project serves neighboring municipalities as well.

ANNEX B

Municipal Bonds in the Czech Republic

Municipality		Year of Issue	Maturity (years)	Amount in Kč (mill.)	Interest in %	Underwriter
No	Name					
1	Ostrava[a]*	1992	6	8.5	d+1-5%	City Hall Itself
2	Šumperk	1993	5	20.0	18	Csl. obchodní banka
3	Smr ovka[b]	1994	7	115.0	14.25	Česká spořitelna
4	Liberec	1994	5	100.0	14.25	Česká spořitelna
5	Praha	1994	5	7,294.3	7.25	Nomura International
6	Pardubice	1994	5	50.0	12.7	Komercní banka
7	Ústí nad Labem	1994	5	150.0	12.7	Komercní banka
8	Čáslav	1994	8	90.0	15.5	Burzovní spolecnost pro kapitálový trh
9	Rokytnice nad Jizerou[c]	1994	7	120.0	12.0	Česká spořitelna
10	Veselí nad Moravou	1994	7	10.0	14.1	Velkomoravská banka
11	Rychnov nad Kn nou	1995	7	100.0	13.1	Komercní banka
12	Plzen[d]	1995	5	500.0	11.5	Bayerische Vereinsbank AG-Praha, ING (C.R.) Capital Markets CS First Boston (Praha) Komercní banka

13	Mariánské Lázn	1995	5	200.0	11.5	Komercní banka
14	Brno	1996	7	1,200.0	11.1	Investicní a Postovní banka
15	Frýdek Místek	1996	5	150.0	11.8	Česká spořitelna
16	D čin	1996	7	250.0	12.5	Československá obchodní banka
17	Kladno	1996	7	250.0	12.5	Československá obchodní banka
18	Ostrava[e.]	1996	5	1,318.2	LIBOR+0. 225%	ING Barings
19	Zidlochovice	1997	10	40.0	12.9	CMZRB
	Total			11,966.0		

a. Ostrava paid off their bonds in 1995.
b. Smr ovka issued only the first tranche of the bonds and the municipality does not intend to issue the second tranche in 1996.
c. Rokytnice issued the first tranche (Kč 60 million) in 1994 and the second tranche (Kč 60 million) in 1995.
d. Plzen issued the first tranche (Kč 300 million) in 1995 and the second tranche (Kč 200 million) in 1996 (at the same interest rate).
e. The Bonds were issued in Deutch Mark (75mill) and placed at London Market. The exchange rate valid on December 20, 1996 (17.576) was used for transferring the money on the municipal account.

Total municipal bonds issue as of December 31, 1996: Kč 11,926.0 million (excluding Prague: Kč 4,631.7 million).
Total outstanding bonds as of December 31, 1966: Kč 11,917.5 million (excluding Prague: Kč 4,623.2 million).